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TO AUTHORIZE A NATIONAL USURY CEILING

ORIGINAL

HEARINGS

BEFORE THE

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES

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TO AUTHORIZE A NATIONAL USURY CEILING

THURSDAY, AUGUST 19, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
Washington, D.C.

The subcommittee met, pursuant to call, at 10 a.m., in room 2128, Rayburn House Office Building; Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Representatives Fauntroy, Hubbard, Patman, Hansen, McCollum, and James Coyne.

Chairman FAUNTROY. The subcommittee will come to order.

Today, we will hold hearings on one idea for dealing with the oppressive problem of high interest rates: Imposition of a national usury ceiling establishing a maximum interest rate that can be charged for any loan.

Despite recent declines, interest rates remain at historically high levels. Home mortgage rates for purchases with a 20-percent downpayment averaged 16.7 percent in July, only slightly lower than the peak rates of 17.8 percent last October. The prime rate for commercial loans is now at 14½ percent, which is still too high, especially for small businesses who have to pay several percentage points above prime for their loans. Consumer credit is only available at high double-digit rates. In these circumstances, it behooves us to give attention to any proposal for achieving lower interest rates.

This hearing is being held to explore the efficacy of these proposals. While one of the most prominent of these would provide that the interest rate which may be charged on loans greater than $300 shall not exceed 10 percent per annum, other proposals range from those which would have the Federal Reserve impose a national usury ceiling, authorizing the President to establish a national interest rate ceiling, limiting the interest the Federal Government may pay on the national debt, establishing an index to control interest rates on a national level, and establishing a congressionally set discount rate. Additionally, while this hearing will not touch upon it, there are also proposals being advanced which would direct the Federal Reserve to set various real interest rate targets. Each proposal advanced has its proponents and its opponents; more than likely, each proponent and opponent has a kernel of truth in his proposition which, when distilled with those truths from others, can guide this subcommittee to the development of an interest rate policy which will be beneficial to our country. So, I commend each of you for taking the time to develop proposals which can be scruti-

nized by this subcommittee and, more importantly, I commend each of you for taking the time to join us and give testimony before a much needed and wanted congressional adjournment.

Among the issues which must be considered before we consider adoption of a national usury ceiling are the effects of such limits on productive lending versus speculative borrowing, on the flow of funds to different sectors, on the present liquidity crisis, on volatility in interest rates, on capital formation, on the health of financial institutions; and on employment. A national usury ceiling would completely reverse the trend to deregulation of the financial industry that we have been following for at least the last 2 years. We must, therefore, know the consequences of deregulation and what the effects of such extensive reregulation would be.

As witnesses today, we have several Members of this House who have taken the lead in sponsoring legislation to impose a national usury ceiling.

Gentlemen, welcome. We look forward to hearing your thoughts on this issue and on your bills. Before we begin, however, let me yield to my friend and colleague, the ranking minority member of this subcommittee, Mr. Hansen, for any opening remarks he may have.

Mr. HANSEN. Thank you, Mr. Chairman.

I want to join you in welcoming our colleagues as witnesses to our subcommittee, and I commend their efforts to deal with unacceptably high interest rates, rates which are obviously artificially high.

As you know, the purpose of this hearing is to discuss the various legislative proposals that have been introduced in Congress by those who feel that establishing a national interest rate policy would be beneficial to our economy. In light of the great amount of discussion and debate given to interest rates this year, I am happy to see this come before us. While I am not a cosponsor of any of the bills that we will be discussing today, I have supported similar legislation in the past as a means of encouraging a constructive dialog on the subject of interest rates.

Mr. Chairman, noting the August 19 Washington Post, where we have a headline stating that the "Street's 'Bad News Bear' Changes His Position." It states that "Henry Kaufman changed his mind Tuesday, and the stock market posted its biggest gain ever."

Kaufman advised clients that interest rates are heading sharply lower over the next 12 months, ending years of pessimistic forecasts.

I think it is very significant where you can have one person in such a position, he can jawbone those interest rates up higher than they ought to be, and maybe it is time, whether we pass legislation or not, that we start jawboning them down.

If Congress can take action and may well take action, it may be that some of these people in Wall Street will get the message that they are not going to hang the country on high interest rates forever.

Federal Reserve Chairman Volcker has been somewhat responsible for the high interest rates by his policies for the past few months, and there has been some change of direction, which is beneficial.

It is very timely that Congress take action.

In many ways, it is too bad we did not begin this discussion several years ago. I would be remiss if I did not point out that interest rates are, in fact, falling dramatically. One year ago, the prime rate was 20.50 percent, and now it stands at 14 percent; the Federal funds rate was 19.71 percent, and now it stands at 9.54 percent; the 3-month Treasury bill rate was 15.65 percent, and now it stands at 8.10 percent; and the 7-year Treasury note rate was 15.04 percent—it now stands at 12.55 percent. This is a healthy sign.

Nevertheless, I think we better at this point assert ourselves, so that we don't find ourselves going into an artificially reversed position if some "Bad News Bear" in the newspaper decides that the country, by the arbitrary whims of one or a few people, are going to go in the other direction. So I look forward to this hearing, and I certainly look forward to the testimony of our distinguished colleague and others this morning.

Thank you, Mr. Chairman.

Chairman FAUNTROY. Thank you. We have also been joined by the distinguished gentleman from Kentucky, Mr. Hubbard.

Mr. HUBBARD. I am a strong supporter of this legislation, and a cosponsor of the same.

I look forward to hearing these five distinguished colleagues of ours who have been waiting to testify.

Chairman FAUNTROY. Thank you and the witnesses for their patience. Presently scheduled to tesfify are our distinguished majority leader, Mr. Wright, the Honorable Gene Snyder, the Honorable Gene Taylor, and the Honorable Carl Perkins, and the Honorable Louis Stokes. We have also received a written statement from Congressman Stangeland. We would now be pleased to hear first from our distinguished majority leader, Mr. Wright.

STATEMENT OF HON. JIM WRIGHT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. WRIGHT. Thank you very much, Mr. Chairman.

I am mindful of the time constraints, so I will try to be as brief as possible.

I do not know that there is anything this Congress could do which would have a more benign or a more lasting effect upon economic revival than the enactment of this legislation.

From time immemorial, times of the Old Testament, people have been against putting their money out to usury.

For most of the history of this country, almost all of the States had usury laws with a top ceiling of about 10 percent. For generation after generation, that promoted economic growth, economic expansion, employment, business opportunities, and the privilege of plain people to better their lot.

There is nothing which is more necessary for economic growth or for upward mobility among the citizenry at large than the availability of affordable credit, credit at rates people can afford and pay back.

High interest rates are inimical to that purpose. There is nothing more conducive to economic contraction, to a polarization of the "haves" against the "have-nots." There is nothing which makes the

rich get richer, and the poor get poorer so much as high interest rates do.

There is no single thing which has contributed so profoundly to this present deep recession as the high rate of interest that has been allowed in this country by the inaction primarily of the Federal Reserve Board.

This is a recession that did not need happen.

This is a recession which was artifically induced. It was a case of artificial insemination of a recession on the part of Chairman Volcker, who decided in October 1979 that the Federal Reserve Board would abandon its historic policy of trying to protect the American public against extortionate rates of interest, and would consider only the goal of money supply.

Always before that time, the Federal Reserve Board had had twin obligations: the one to protect against undue flooding of the markets with money by considering targets for monetary aggregates; the other to protect against contraction in the economy and unemployment-inducing high interest rates.

For the first time, in October 1979, Paul Volcker announced they were abandoning concerns for interest rates. They would just let them float, and they could charge whatever they wished.

The result has been utterly disastrous. The result in 1 year has added 2.6 percent to the unemployment rate, 2.6 percent since the beginning of August last year.

At that time, the unemployment rate was 7.2 percent. Today, it is 9.8 percent. That means that more than 3 million additional Americans have been thrown out of work.

It means, also, that small business, the well springs of sustenance for the American economy, have been clogged.

It means that we have seen a higher rate of business failures than this country has suffered in the past 50 years, so that today, for every hour of every working day, we are seeing 11 businesses fold up somewhere in this country, and as they fold up and close their doors on rusty hinges, more people go out to join the ranks of the unemployed.

Put it another way: About every 5 minutes of every working day, some business fails.

Testimony was given before this very subcommittee, I believe, if not before another subcommittee, on which the gentleman from the District served, authorities on bankruptcy, and the referees in bankruptcy stated that the principal cause for bankruptcies among small businesses was the disproportionate share of the cash flow of those businesses which was consumed unproductively in interest rates.

He testified that approximately 40 percent of the total cash flow of the average small business had to go out in payment of interest.

Now, that is a thoroughly disproportionate drag. It is a burden that the average small business cannot bear, so we are in a desperate situation. It is a crisis. Perhaps it takes a crisis to bring forth the necessary action from Government, just as it took a crisis in the days of Andrew Jackson to bring forth the leadership on the part of the people's elected spokesman to confront the Bank of the United States and say: enough; enough. After all, the people have

something to say about this, and it may be time for us to renew that march.

The bill, I think, is a good one. I wish I could take credit for it. I can't. I joined it as a cosponsor after it had been written by a bipartisan group of my colleagues. There is no single bill that could do more to promote long-term economic healthy growth in the United States.

As you are familiar, the bill would not attempt to impose a sudden usury ceiling in a traumatic way. Rather, it would impose it gradually, so that the financial institutions of our country could accommodate themselves to its pace.

Effective 30 days after enactment of this legislation, there would be a 15-percent annual interest rate above which any interest would be usurious.

After 12 months, it would drop to 14 percent, and in another 6 months, it would drop to 13 percent. After 2 years, it would drop to 12 percent; following 30 months, to 11 percent; and 3 years after enactment, it would come to 10 percent, and stay there.

There is not another thing that this Congress could do which would be so productive of economic growth in these United States, and so it is with great pleasure that I express my wholehearted support of this legislation.

I hope that members of the subcommittee will indulge me, understanding that we have a matter of some importance on the floor, and I am now going back over there to ask them, as I now am asking the gentlemen from Kentucky and Texas, and any others that are here, at least to vote for the previous question on the rule, so that the merits of the bill before the House can be considered.

I just thought I would work that in.

Give us a vote on the previous question.

Chairman FAUNTROY. I thank the distinguished gentleman from Texas for his testimony and for the point just made.

You should also note that the Chair of this subcommittee, while he represents more taxpaying citizens than any other Member of the House, was not included among those you mentioned.

Mr. WRIGHT. Sadly, I omitted it.

Chairman FAUNTROY. Even though I represent more people than any other Member of the House, taxation without representation remains tyranny in the House, because I cannot vote on that. I wish I could. The District still does not have a vote on the floor. Thank you for the clear and perceptive testimony that you have provided us.

Mr. WRIGHT. Thank you very much.

Chairman FAUNTROY. Congressman Wright, I am going to ask that you be allowed to leave, but I would like very much for the others to remain, and we would like to hear from the rest of the panel, in order, and then we will go to questioning.

Mr. WRIGHT. I will leave it in their able hands.

Chairman FAUNTROY. I recognize the distinguished gentleman from Kentucky, Mr. Snyder.

STATEMENT OF HON. GENE SNYDER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KENTUCKY

Mr. SNYDER. I want to thank you personally for giving us an opportunity to have a hearing on this legislation which the majority leader has indicated, the sentiment of all of us here on this panel, we believe to be very important and the best contribution this Congress can make to the economic revival of this country.

Mr. Chairman, housing starts are at their lowest levels in 35 years, there is 25-percent unemployment in the auto industry and 35-percent unemployment in the steel industry. There is a business bankruptcy every 69 seconds. Housing starts are at a 30-year low. Unemployment is sitting at 9.8 percent and showing no signs of improving. The economic recovery we have all been counting on being just around the corner keeps ducking around another corner.

And with each of these dismal statistics, and all the pain they represent, the Federal deficit projections grow continually worse, sowing the seeds of even more pessimism and pain for the future.

The cause of all these problems is not really in dispute. The question is not what is causing our Nation's economic problems. Virtually everyone agrees that stubbornly high interest rates are the culprit behind this recession which is bloating the Federal budget deficit, enervating our Nation's economic growth, and spawning unemployment, bankruptcy and pain.

The question is, who is responsible for those interest rates, and then, after we answer that one, the question is what should be done to bring those interest rates down to reasonable levels?

The answer to the first question, who is responsible for the interest rates, is an easy one if we dig through the rhetorical camouflage which has been thrown up around it. Certainly it is easier, and certainly considerably safer politically to sit back and throw rocks at the Federal Reserve Board and blame them for the conditions in the money markets and the economy. Its easy and safe to pretend that the Federal Reserve Board or its policies are wrapped in the mystical mantle with the title of an independent agency and is untouchable.

As the members of the subcommittee know so well, the basic law of this land, the U.S. Constitution, does not even mention a Federal Reserve Board. That Constitution says that the responsibility lies directly on this Congress. According to that basic law of the land, the U.S. Congress has not only the right but the responsibility to "coin money and regulate the value thereof." We can blame the Fed all we want. We can wail and moan at the administration for not putting more pressure on the Fed.

But when it all comes down to the bottom line, it is our responsibility, the Members of the U.S. Congress, to put the situation right.

That's why I am here today with my colleagues, because we recognize Congress responsibility to establish basic monetary policy. And that's why we are here to testify in favor of H.R. 4572, the National Usury Act, because we believe it is the answer to the second question, what should be done to bring interest rates under control?

As you know, interest rates have historically risen and fallen with the inflation rate, generally riding along 2 or 3 points above

inflation. Last year, inflation fell off dramatically and the experts—the administration's, CBO's, private forecasters, everyone, predicted that interest rates would do the same. They didn't.

Late last year and early this year, with inflation showing even more signs of cooling off, the same experts predicted a substantial drop in interest rates in time to fuel a spring recovery. Then, when that didn't materialize, they predicted an early summer drop.

Finally, in the last few weeks, we have seen a welcome dip in the prime, but the point is the fall in inflation which began 2 years ago should have been followed by a fall of interest rates but interest rates did not tumble and still have not fallen as far or as fast as they should have.

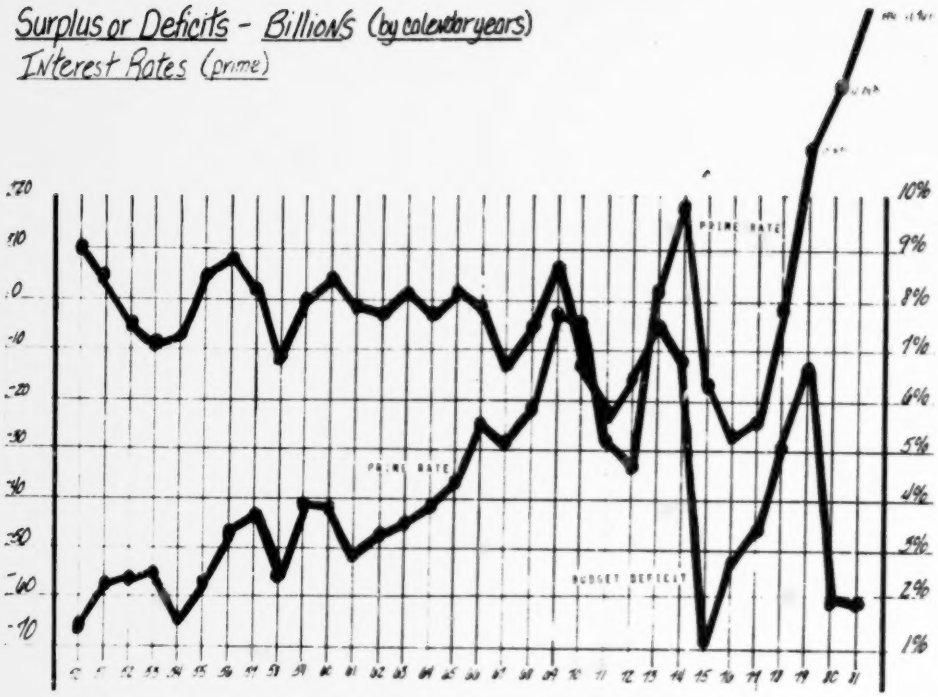
The real interest rate, the rate paid for money over and above the inflation rate, has generally averaged about 2 or 3 percent. But in 1980 the real interest rate soared to 8½ percent and it is still hovering around 7 percent. That is three to four times the normal real interest rate. The economists admit there's no economic reason for it. The monetarists can't explain it. There's simply nothing in the textbooks to justify real interest rates at current levels.

Of course, early this year, it became popular to blame the high interest rates on the huge deficits projected for the Federal budget.

That's a handy explanation if you happen to be trying to sell a tightfisted budget at the time or if you happen to be the chairman of the Fed trying to dodge flying stones. But as far as I'm concerned, and as far as history is concerned, the theory that deficits cause high interest rates just doesn't wash.

In calendar year 1969, we had a budget surplus but interest rates went up. In 1975 we had the largest budget deficit in our Nation's history up until that time, but interest rates went down 2 points. In 1979 we had a deficit one-fourth as large as the 1975 deficit and interest rates went up 3 points. If you chart it out—we have done that, Mr. Chairman, and I am going to leave this chart here for you and the other members of the subcommittee to look at—interest rates have generally gone down when deficits go up.

[The chart referred to follows:]



There is no question that the competition of the Federal Government for available funds exerts a very strong upward pressure on interest rates. But it cannot explain today's high interest rates, the level of competition has not increased dramatically in the past few years. The debt has nearly doubled in size since 1975, but so has the GNP and gross private domestic investment.

I am all for cutting the deficit and I am convinced that balancing the budget is critical to the survival of our Nation's economy, but cutting the deficit will not automatically bring interest rates down. We can't count on that.

On the other hand, cutting interest rates would help reduce the deficit. Next year the Treasury will have to refinance over $290 billion of the existing public debt, interest-bearing debt, as well as finance whatever we end up with for a deficit in the 1983 budget.

Each 1-percent drop in interest rates would save us nearly $2.5 billion in fiscal year 1983, twice that much in 1984, and ever-increasing amounts as more of the existing debt is rolled over and refinanced at lower rates. That's all painless savings without cutting a single program of any kind.

Cutting interest rates would also stimulate the economy and get us on the road to recovery, putting people back to work, and setting the economy free to grow again.

Each 1-percent decrease in unemployment nets the Federal Treasury $28 billion. And each 1 percent growth in the economy brings an additional $17 billion into the Treasury. Theoretically, if we reduced interest rates sufficiently, we could still end up with a balanced budget rather than a $120 to $160 billion deficit in 1983.

So if reducing interest rates is our goal, and it obviously should be, how do we bring them down to reasonable levels; how do we think out the unnaturally high real interest rates which are plaguing us by sitting like a huge monkey on the back of our economy?

I think the answer lies in looking to history and seeing what developments brought us to the present situation. Two developments come immediately to my mind, the dismantling of and the loss of effectiveness of State usury laws and the switch in policy at the Federal Reserve Board from targeting interest rates to a policy of targeting aggregate money growth rates.

Ten years ago we had fairly uniform State usury ceiling nationwide. Unless you dealt with Mafia loan sharks, you never ran into 16- or 17- or 18- or 20-percent interest rates.

Unfortunately, when money got a little tight, particularly in the early 1970's, the States started competing among themselves by raising or discarding the usury limits to siphon capital from their neighbors with lower usury ceilings. As long as they were uniform, the usury laws helped stabilize interest rates but when their uniformity was destroyed, their effectiveness was lost.

The second major development that helps explain our current situation is the change in Federal Reserve Board policy in 1979 when Chairman Volker came on board. The Fed gave up its policy of controlling inflation and/or money growth by regulating the reserve requirement of lending institutions and went to a policy of controlling that growth simply by price, that is interest. When the credit/money growth was controlled by reserve requirements, admittedly only the best credit risks got money, but some did. Today, all borrowers are virtually priced out of the market and the economy is stifled.

In any event, it is no small coincidence that the real roller coaster fluctuations in the price of money began when the Fed shifted its attention from regulating reserves to pricing money to control the supply.

The combination of these two developments, the scuttling of uniform State usury laws and the shift in Federal Reserve policy, contributed a new volatility to the money markets never before experienced. Prior to these developments, the prime rate was not a weekly news headline. It might have changed once or even twice a year, but never on a monthly or weekly basis as it has in the past 2 or 3 years. And this increased volatility, this roller coaster of dips and climbs has created a general uncertainty in the marketplace, an uncertainty which, more than any other factor, has inflated real interest rates.

It is this uncertainty that is the primary culprit behind today's outlandish real interest rates. Lenders have been burned by the gyrations in money prices too many times in the past few years. They don't want to expose themselves because they have lost faith in the forecasters and are gunshy about believing that Congress or the Fed will have the will to stick to any one policy for more than a few months at a time.

Because of this uncertainty and the new elements of risk created by the roller coastering money markets, lenders are now regularly adding a new component to the interest rates, a fear of volatility

premium to insure themselves against the possibility of an upward surge in the rates they must pay for money.

It is the emergence of this volatility premium which is inflating interest rates, holding them at artificially high levels.

If you recognize this volatility premium as the culprit, the solution is readily apparent, we need to replace uncertainty in the market with certainty and replace that volatility with a guarantee of stability.

It stands to reason that if we could provide lenders with some reasonable assurance that they don't need to worry about a dramatic upsurge in the rate they must pay for money, they wouldn't need to add their 4- or 5-percent insurance premium and interest rates could fall that much immediately.

This is where H.R. 4572 comes in. Because it is a National Usury Act, it would not be prone to the State-by-State tug-of-war that plagued State usury laws.

Because it sets a fixed schedule for phasing in lower interest ceilings, going for 15 percent to 10 percent over a 3-year period, it would provide the assurance that lenders need to make long-term plans with some semblance of certainty and, therefore, make fear and volatility premiums unnecessary. It would provide a guarantee that the roller-coaster ride was over.

Frequently, usury laws are criticized as an effort to distort the operation of the marketplace, the supply and demand. That is not the case here at all. The phase-in schedule for maximum allowable rates of interest is not an attempt to reduce interest rates to artificially low levels. It is an attempt to eliminate an artificial component in interest rates created in response to the Federal Reserve Board's erratic control of the money supply. What could be more distorted than the market as it is?

Another criticism launched at usury laws is that they run contrary to the trend toward deregulation. Again, the argument is empty. The Federal Reserve Board already has a virtual monopolistic grip on the supply side of the supply-and-demand equation. Forcing the Fed to shift its attention back to the cost side, where it used to be, does not significantly increase Government intervention in the market.

In your invitation, you raised several questions on the potential impact of usury ceilings and I will now try to respond to some of them.

Since the usury limits envisioned in H.R. 4572 are not intended to force rates down to unnatural or artificial levels but rather aimed at eliminating the need for padding rates which has resulted from a very unnatural series of fluctuations in the cost of money, there is no reason to suspect that a usury ceiling would result in a restructuring of lending priorities.

It is generally assumed that, if inflation begins to lift the nominal interest rates to the point where they bump into a usury ceiling, it will push high-risk, low-income customers out of the market. However, exorbitant interest rates have the same effect now. I am not sure that it is any worse to be unable to obtain a loan you can't afford than it is to be unable to obtain a loan you could afford. Either way, you're shoved out of the loan market.

The point is that, under a usury ceiling, in tight money situations, at least some borrowers could get funds at reasonable rates.

As it stands, the Federal Reserve's current policy goal is to starve out inflation but the problem is that the economy is paying filet mignon prices to starve. High interest rates are themselves inflationary. Since everything that is bought, sold or produced in this country depends on borrowed money at some point, those high interest rates become part of the final price. High interest rates are inflating the inflation that the Fed is trying to starve out.

I remember when the prime was about 20 percent a year and a half ago or so, and a friend of mine who is a Lincoln Mercury dealer, it cost him $150 a month to do a floor plan for every Lincoln sitting in his showroom.

He had to put that into the price of every vehicle. That had to be put in as a part of the inflation factor.

The present liquidity crisis and the pent-up demand for funds will certainly put a great deal of pressure on the supply of money as interest rates fall. That's another reason we favor the idea of gradually reducing the maximum rate allowable rather than doing it in one fell swoop.

But the long-range certainty provided by the fixed interest ceilings would have to have a very positive impact on long-term rates which would set the stage for improvement and certainly help restore the vitality of industries like housing which are dependent on long-term loans.

Reducing interest rates, whether by a usury ceiling or any other means, would certainly have to have a dramatic impact on the well-being of the traditional financial institutions and a particularly positive impact on the savings and loans and small banks who have been unable to compete effectively with money market funds at high levels of interest. The attractiveness of money market funds would probably be reduced as interest rates fall and Merrill Lynch might not be too happy about it but reduced interest rates, whatever their cause, would have that effect and lower interest rates, no matter what their cause, would be a fresh breath of air to the traditional S&L's.

As I mentioned earlier in my testimony, the imposition of usury law should not be seen as a reversal in the trend toward deregulation—rather, as a redirection of existing controls. Under the limits imposed by a usury law there is no restriction on competition, there is complete freedom to charge and pay any rates of interest as long as they don't exceed the ceiling.

The lower rates of interest that would be charged by lending institutions would naturally result in lower rates of interest paid to savers and depositors. It might take some getting used to traditional single-digit returns after what we have experienced recently.

However, I would assume that investors would still have to invest their surplus funds wherever they could get the best return with the greatest security. Lower interest rates on savings deposits may encourage some investors to direct investment but any loss in deposits from the lessened incentives of lower rates should be offset to a great degree by the increased incomes and economic activity generated by the stimulating effects of lower rates.

I think everyone would be satisfied if we could return to 1967 when banks paid 3- or 3½-percent interest rates, charged 5-percent prime, and we had a personal savings rate of 8.8 percent, 2 percentage points higher than the savings rate we have now with all the double digit savings vehicles and money markets available.

What we basically have here, in our proposal to establish a National Usury Act, is a redirection of the Federal Reserve's attention to the cost of money, where it should have been all along, coupled with a legal guarantee to reassure all lenders and borrowers alike that the roller coaster ups and downs in the price of money is at an end. The National Usury Act is simply a straightforward way to provide the players in the money market some semblance of certainty on which they can make long-term plans so that interest rates can fall to normal levels.

The immediate results of supplying that certainty would be a healthy economic recovery and a greatly reduced Federal deficit. The benefits are very real. The costs and dangers are negligible.

I urge the subcommittee to give the usury concept its careful and, hopefully, favorable consideration.

I firmly believe that it is the answer to the increasing economic instability, the inflation, the declining productivity, the credit markets out of control, record unemployment, and record bankruptcies.

Thank you, Mr. Chairman.

Chairman FAUNTROY. I thank you, Mr. Snyder.

I have noted the bipartisan nature of the sponsorship of this measure, and for that reason I intend to alternate between the parties. If there is a member of the panel who has a pressing schedule problem, please let me know. If not, we will hear now from the distinguished gentleman from Kentucky, Mr. Perkins.

STATEMENT OF HON. CARL D. PERKINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KENTUCKY

Mr. PERKINS. First let me thank you, Mr. Chairman, and all of the members of the Subcommittee on Domestic Monetary Policy.

I appear here today in behalf of the bill, H.R. 4572, introduced by Congressman Snyder, myself, and the other Members of the Congress. Naturally, I feel that something must be done.

I feel that the hour is late. I feel that we are spinning our wheels insofar as balancing the budget, because the budget will never be balanced as long as we have the high interest rates. There is just no way to do it.

You can take a seventh or eighth grade mathematician; they can tell you that we are confronted with a no-win situation in the U.S. Congress, as long as interest rates are so high.

We heard all of these promises about the economy made a year and a half ago, and we all know what happened to those promises. It just was not in the cards because of the high interest rates.

The Federal payment is going to be the biggest item in our budget within a very few years, and it is an unnecessary expense item.

I do not think any of us want the big banks to destroy the country, but that is the way that we are headed at the present time. True enough, the interest rate has dropped in the past few days,

but that is just a temporary thing. It is going to jump right back up.

I do not mean to lay all of the responsibility on the Republicans. The Democrats are likewise responsible. In 1979, of course, when Volcker restricted the money supply, and ever since then he has had no regard for the people in this country, which is a shame, a shameful, disgraceful situation, and will bankrupt more industries.

You can see it any way you want to look at it.

The automobile industry has been largely captured by foreign manufacturers because of high interest rates.

The tax breaks that the President gave the bigger corporations of the country, I don't think are being used for reinvestment. I know what United States Steel did. They went across the river from me down there, and bought out a thriving oil and gas company, Marathon.

The stock jumped during the negotiations from about $65 to $130 a share. Marathon has several thousand profitable gas wells in the country that Mr. Patman comes from and in Louisiana and other places, and buying it took United States Steel's income, instead of modernizing their own machinery. And we all know about all these investments overseas in real estate and everything else, draining all of the money off, and with the unemployment situation and with the bankruptcies in this country, we are not going to fool the people, none of us, very much longer here in the U.S. Congress, claiming that we do not have anything to do with this problem. The problem is altogether in our hands.

The Federal Reserve, if it is to have authority in the future, will have to have restrictions. We have to do something about the situation. That is the reason I am supporting this bill. It is a very moderate approach to the situation.

I asked the General Accounting Office to study the interest rate problem on July 11, and they told me they would have something the last part of August. If the record is not closed I will send it to you.

If you get a bill out on the floor this year, which should be done, I want to say to you gentlemen, it will pass. There will be over 400 signatures on a bill of this nature on the floor and the bill will pass overwhelmingly, and Mr. Volcker would be controlled somewhat.

We should not waste any time in reporting the bill to take care of the masses of the people of this country, and the small industries of this country by the hundreds of thousands. I mean it is a shameful situation to let a situation of this type go along under the control of Mr. Volcker.

Wright Patman, the father of Mr. Patman up here on this committee, predicted everything that was going to happen. If you will go back and read his speeches about turning this Federal Reserve loose, you will see how correct he was. And it was turned loose under President Carter. But the Fed is finding plenty of buddies now within this administration, and the administration is not going to do a thing about interest rates, except create high unemployment. It is time for us to take some action and if you will take action and get a bill out of this committee, I will guarantee you that the House of Representatives will in my judgment pass it overwhelmingly. And the American people, by the time the debate

is over, will know what this is all about, and they will know that it is not alogether deficit spending that is bringing the situation about.

The big bankers of the country have done more to bring about deficit spending than anyone else, and we should face up to it and do something about the situation in this country. And I am hopeful that the committee will report something out that will let business get back on its feet. Every small business in the country is going out of business.

You have no idea of the mergers that have taken place and it will continue to take place right on unless we stop this situation. Today we are talking about interstate banking.

If the big banks cared for humanity, suffering humanity, and for little businesses, it would be a horse of a different color, but they have already displayed that they have no regard for small businesses in this Nation. It is all big business.

Money, for all intents and purposes, is already rationed by the Federal Reserve and by banks. You can take Sears and Roebuck and many of these big corporations, and they are merging on borrowed money, and our little businessmen, the people that want to buy a home or the people that want to buy a new automobile just cannot afford to borrow money.

We are depriving a younger generation of homeownership.

I know what the situation is in my district and throughout the Appalachian area, and I think it is that way throughout the country, and I think we have to do something.

As Mr. Snyder stated, all you have to do is read the Constitution. The Constitution says Congress has the authority to coin money, regulate the money.

We passed the Federal Reserve System in an attempt to try to balance the banking business out and make the banks more safe, but they are running the country today for all intents and purposes, and it is something that I would hope that this committee would take action on. It is the duty and responsibility of us all to work for the general welfare of all the people in the country, and our little banks don't like this situation. There is nothing they can do about it.

The policy is set by the Federal Reserve and Vocker and his cohorts in big banking. Mr. Hansen mentioned jawboning during the Kennedy administration and the Johnson administration, but that is not going to be worth a tinker's darn with this administration. They have a buddy-buddy relationship with big business.

I would like to see something on the floor that we could vote for, work our will on and pass to help the masses of the people, help small industries, help the homeowners, help people buy homes, help the automobile industry, all the industries in the country, and we are not going to do it until we do something about this interest situation.

This thing of interest flopping up and down a percentage point here, a percentage point there, it is not going to solve this problem. If we balanced the budget today, these big bankers would keep the interest rate 18, 16, 17 percent, so we might as well get something out of this committee and I hope we do it right away.

Thank you.

[Mr. Perkins' prepared statement follows:]

Statement of Rep. Carl D. Perkins
August 19, 1982
Subcommittee on Domestic Monetary Policy
Committee on Banking, Finance and Urban Affairs
2128 Rayburn Building

I would like to thank the Chairman and the Members of the Subcommittee on Domestic Monetary Policy for giving me the opportunity to discuss, for a few minutes, my ideas on interest rates. When I received your letter inviting me, I responded by asking that I be permitted to provide a statement for the record. I did that because a few weeks earlier, I had written to the Comptroller General, asking for an investigation by the General Accounting Office into the interest rate problem, and for recommendations on actions Congress might take to control interest rates.

I would like to see the General Accounting Office response before I tender my statement, and I hope that I will have it before the hearing record is closed.

Mr. Chairman, I would like to mention that we are all relieved to see what looks like a decline in interest rates -- perhaps somewhat steadily -- but let's not think for a minute that our problems are solved.

Mr. Kaufman, the economist who seems to control interest rates about as much as the Federal Reserve Board, through his predictions, said a decline is underway, and the stock market

followed with its biggest increase in history. But Mr. Kaufman also said that there would be irregularities in the decline, and he also used the expression "dramatic interruptions."

This decline, welcome as the flowers of May, is still t ate for thousands and thousands of farmers, small coal oper tors, and other small business people. They are broke, bankrupt.

If we want to save the rest of the economy, the farmers and small business people gasping for economic breath, then -- one way or another -- we have to control interest rates.

I know most economists say you can't do it. To my way of thinking, that is as good a reason as any to go ahead and do it.

You have legislation before you submitted by Members of your Committee, other Members of the Congress, and a new bill circulated for co-sponsorship by the Majority Leader, Mr. Wright, to consider.

There is just one additional point I would like to make, Mr. Chairman. The Constitution says the Congress has the power "to coin money (and) regulate the value thereof."

Let us use our power to control interest rates, and save the economy of the country.

Chairman FAUNTROY. I thank the gentleman from Kentucky.

Without objection, the record will remain open through the end of the month, and we will insert in the record, at this point, the GAO study, if it is available.

Mr. PERKINS. The General Accounting Office findings go in the record. I will get them here for you.

Chairman FAUNTROY. I next recognize the distinguished gentleman from Missouri, Mr. Taylor.

STATEMENT OF HON. GENE TAYLOR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. TAYLOR. Thank you, Mr. Chairman.

I want to express my appreciation for the opportunity of being here today to discuss the merits of H.R. 4572, our proposal to establish a national usury law.

I am also joined in the testimony that I will offer by my colleague, as you mentioned, Hon. Arlan Stangeland of Minnesota.

As our bill states, the process would not be an instant one, nor is it my belief that it would be detrimental to our money-lending institutions. The bill provides for a gradual phasedown, over a 36-month period, of the exceedingly high interest rates that best our Nation today.

I would like to say this, Mr. Chairman: Years ago our banking institutions, the banking industry in this Nation, was made up of many thousands of small banks across the length and breadth of this Nation, each one of them having the repsonsibility to serve the people in the communities where they were located, each one of them making loans to their customers, using their own prudent judgment based upon that person's moral and other attributes, and it served America well.

We saw a transition in this banking system during the past few years, as the large banks, and the large centers of financial communities began to expand and to bring these banks into the fold. What we have seen is the enveloping of our small banks into a small group of large banks that today control the interest rate that the American people are being forced to pay.

No longer do our small bankers have the opportunity and the privilege and the prerogative of making these loans to people that they know, who are their friends and neighbors. The full service bank is gone. The small bankers of this Nation and the bankers in my district are frustrated because they have been relegated to money jugglers, who find every morning they have to go down to the bank and get on the telephone and start juggling money backward and forward to the big cities, while the farmers, the small businessmen, and others, are shoved aside because the rates that are being charged cannot be afforded.

So, Mr. Chairman, I feel that this is a very, very important piece of legislation.

At the outset let me assure our friends in the banking and savings institutions that we realize the need to provide protection for them vis-a-vis the rate they must pay to obtain the funds as opposed to the rate at which they will be permitted to loan money. We are fully aware of the basic requirement for such a spread.

I know, too, Mr. Chairman, that our banks and savings and loan companies are also very concerned about interest rates.

I talk to my bankers and the loan people every day. No one is more concerned and frustrated than they are. They see the erosion of their customers' equity and the deterioration of their collateral. They realize we are in a no-win situation.

I do submit, however, Mr. Chairman, that we must put some sort of clamp on the outlandishly high rates of interest that beset this Nation today if we are ever to regain our economic vitality.

Virtually every ill that affects American business and industry can be laid at the doorstep of high interest. Unemployment in automobile manufacturing, in housing, and in building in general are the direct result of high interest. The farm economy is hurting because of high interest.

In fact, everyone in America who wants to buy something, whether it be a new car, real estate, household appliances, or even food and clothing, have all had second thoughts because of the rate of interest they would be required to pay, either directly or indirectly.

We know, for example, that reducing interest rates would reduce the deficit. Each 1-percent reduction in interest rate would reduce the deficit as much as $5 billion in fiscal 1983 and $6.5 billion in fiscal year 1984. Furthermore, reducing interest reduces unemployment and reducing unemployment increases Federal revenues. For every 1-percent reduction in unemployment we reduce outlays by $11 billion for fiscal 1983 and increase revenues by $17 billion at the same time.

There is a difference of $28 billion a year with a reduction of 1 percent in the interest rate that would not affect our national budget.

Mr. Chairman, I have not yet found an argument in opposition to a national usury ceiling that I believe holds water. Some studies I have read contend that such a cap would lead to a recession. The fact is, we are in a recession caused mainly by the high interest rates that now prevail. Studies contend that a cap would lead to high unemployment and loss of economic efficiency. That is exactly what is occurring today because interest rates have been high for too long a time.

The record high interest rates that we have experienced since 1980 shortly after Paul Volcker was confirmed to head the Federal Reserve Board of Governors has caused a record number of bankruptcies, the highest unemployment in 50 years, and a loss of confidence in America's leadership by our foreign allies who rely on a stable America for economic stability worldwide.

Today in the United States, virtually every man, woman, and child have become knowledgeable of and concerned about the basic money supply. Four years ago only a handful of our citizens had even heard of M_1. Most thought it was a new version of the World War II infantry rifle. Today everybody knows what it is and searches their newspaper each week to see whether the money supply has gone up or down. They read about M_1 before they read "Peanuts" in the comic strip. This is symptomatic of the depressing effect that high interest is having on the Nation as a whole.

I contend that this problem is not unsolvable. Our States have had usury ceilings for years and they have worked successfully. That is until the enactment of Public Law 96-221, which permitted the Federal Government to override State laws on usury. Furthermore, we have had national usury laws before.

I am informed by the Library of Congress that the National Bank Act of 1863 limited federally chartered banks to the interest rates allowed by the laws of the States or territories in which they were located. One section of the act provided that if there was no such law, interest rates could not exceed 7 percent.

Mr. Chairman, I believe that a national usury ceiling would be good for America. It would provide certainty in the marketplace, would not deter investment, nor would it discourage savings.

I would recommend that the committee report this measure to the House so that it can be debated and the Members of our House have an opportunity to vote on its merits.

Thank you.

It is our responsibility, our moral and our legal and constitutional responsbility to address ourselves to this compelling problem that imperils the lives of the American people, and I think it is time. Time is short, and I hope very sincerely that this subcommittee would like to give the Members of the House of Representatives an opportunity to act on this very important proposition.

Thank you very much.

Chairman FAUNTROY. And I thank you, Mr. Taylor.

We now move to Mr. Stokes, the distinguished gentleman from Ohio, a member of the Standards of Official Conduct Committee and the Appropriations Committee. Welcome, and we are very pleased to receive your testimony.

STATEMENT OF HON. LOUIS STOKES, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. STOKES. Thank you very much, Mr. Chairman.

I have a rather lengthy formal statement, and I would ask that it be incorporated and printed in the record in its entirety, and I would at this time make a brief statement.

Chairman FAUNTROY. Without objection, so ordered.

Mr. STOKES. Thank you. Let me express my appreciation to you and the members of the subcommittee for affording us the opportunity to appear here on behalf of this legislation.

I wish to express my appreciation to the gentleman from Kentucky, Mr. Snyder, who sponsored this legislation and the opportunity he provided to us as Members of Congress to cosponsor this legislation.

I feel like the distinguished majority leader who said this morning that it is the type of legislation one wishes he had been the originator of. I am very proud to be a cosponsor, but I think the gentleman is to be commended for initiating this legislation.

I think, Mr. Chairman, this legislation is like an idea whose time has come, and I agree totally with the distinguished chairman from Kentucky, Mr. Perkins, who said that if this legislation goes to the floor of the House, it will pass overwhelmingly.

Over the last few years, many States have raised their interest rate ceilings well above current market rates, sometimes indexing ceilings to a market indicator set by a commission or a special committee. In the past, States have been able to respond quickly enough to avoid the crisis of sky-high interest rates, like the ones we see today. However, in the last several years, interest rates have been notably unstable, especially for short-term debt. These interest rates have left several States in a veritable lending standstill for most, if not all types of loans.

A decade ago, when this Nation had fairly uniform State usury laws, the borrower would not have encountered interest rates like these, unless he dealt with an underworld loan shark. State laws no longer express interest rates in a uniform manner and rates may range anywhere from 16 to 40 percent.

These variations in State statutes affect the cost of consumer credit throughout the United States. For example, the Illinois usury ceiling of $12 per $100 per year on new motor vehicle loans amounts to nearly 24 percent expressed as an annual percentage rate—which takes into account the declining balance of an installment loan. The usury ceiling on motor vehicle loans in the State of Vermont is 18 percent per year if the loan is secured for a vehicle of the current or previous model year; 20 percent if secured for an older vehicle. Moreover, in the States of Oregon and New York, there are no usury ceilings on motor vehicle loans, and the lender may charge any rate of interest he chooses.

Credit on revolving charges, mortgages, and automobiles are the major types of credit which consumers wish to have access to. For residents of those States having no usury ceilings on credit of this type, it is becoming more and more difficult to acquire credit at reasonable rates. Therefore, a majority of the time these persons must do without the immediate benefit of some desired goods or service.

Unparalleled high interest rates are also killing the housing and automobile industries, along with the hopes and dreams of millions who cannot afford the high cost of credit. Small businesses are being crippled by the thousands—with bankruptcies increasing at dramatic rates. The American people are begging the Congress and the President to do something about it. At every town meeting I have had, someone questions me as to why officials in Washington don't do something about those high interest rates. I felt a little inefficient saying to people, well, that is the responsibility of Mr. Volcker—and shuck my responsibility. This is a way for us to address this question seriously as Members of Congress.

The Reagan administration, with its plan for economic recovery, has thus far been unable to steadily control interest rates. While the rate of inflation may be curbing, the interest rates have never taken any continuous climb downward. Despite all the talk of economic recovery, the American people will never be able to attain affordable housing, automobiles, and consumer credit until interest rates go down. Additionally, until interest rates come down, the economy will be unable to create jobs; and employees of those industries dependent on the consumer's ability to attain credit will be laid off. We will never have real economic recovery until we are able to put a clamp on interest rates and put people back to work.

The trend at the national level is increasingly toward Federal regulation of interest rates. Already in existence are Federal laws that regulate other aspects of the loan industry, such as criminal loan sharking and disclosure, which have withstood scrutiny under the commerce clause. Loans and interest rates can no longer be considered purely a State phenomena any more than loan sharking is, and thus the reality of a viable national economy should enable Federal legislation to be considered. We must not allow the current trend in State legislatures of relaxing usury laws to continue.

If this trend continues more and more persons, typically low- and middle-income families, will be forced out of the credit market altogether. There is indeed a great indication that legislation which would establish a universal usury ceiling should be enacted immediately. I would urge our colleagues who are members of this subcommittee to continue holding hearings on this legislation, and hopefully that you will vote out this bill now before you.

[Mr. Stokes' prepared statement follows:]

TESTIMONY BEFORE THE COMMITTEE

ON BANKING

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

I wish to commend the distinguished Subcommittee Chairman, Mr. Fauntroy for holding hearings on H.R. 4572, The National Usury Act. It is indeed a pleasure for me to speak before your Subcommittee today.

Usury is a concept as old as human society, dating at least from biblical times. Usury is usually defined as the charging of a greater rate of interest than allowed by law for a loan or forebearance of money or property. State usury laws were designed to eliminate exorbitant rates of interest and any rate of interest above the state usury ceiling is considered to be immoral and contrary to public policy. Additionally, usury laws have the implicit objective of ensuring the availability of credit at fair rates.

The rationale behind most usury laws is basically unchanged from that of the biblical prohibition: to protect the needy from those who would take advantage of their position. However in recent years, very little attention has been paid by state legislatures to keeping interest rates under control. Laws that were designed to protect the "borrower" from being charged excessive rates of interest are heedlessly failing.

Over the last few years many states have raised their interest rate ceilings well above current market rates, sometimes indexing ceilings to a market indicator set by a commission or a special committee. In the past, states have been able to respond quickly enough to avoid the crisis of sky-high interest rates, like the ones we see today. However, in the last several years, interest rates have been notably unstable, especially for short-term debt. These interest rates have left several states in a veritable lending standstill for most, if not all types of loans.

A decade ago, when this nation had fairly uniform state usury laws, the borrower would not have encountered interest rates like these, unless he dealt with an underworld loanshark. State laws no longer express interest rates in a uniform manner and rates may range anywhere from sixteen to forty percent. These variations in state statutes affect the cost of consumer credit throughout the United States. For example, the Illinois usury ceiling of $12 per $100 per year on new motor vehicle loans amounts to nearly 24% expressed as an annual percentage rate (which takes into account the declining balance of an installment loan). The usury ceiling on motor vehicle loans in the state of Vermont is 18% per year if the loan is secured for a vehicle of

the current or previous model year; 20% if secured for an older vehicle. Moreover, in the states of Oregon and New York there are no usury ceilings on motor vehicle loans and the lender may charge any rate of interest he chooses.

Credit on revolving charges, mortgages and automobiles are the major types of credit which consumers wish to have access to. For residents of those states having no usury ceilings on credit of this type, it is becoming more and more difficult to acquire credit at reasonable rates. Therefore, a majority of the time these persons must do without the immediate benefit of some desired good or service.

Unparalleled high interest rates are also killing the housing and automobile industries, along with the hopes and dreams of millions who cannot afford the high cost of credit. Small businesses are being crippled by the thousands--with bankruptcies increasing at dramatic rates. The American people are begging the Congress and the President to do something about it.

The Reagan Administration, with its plan for economic recovery has thus far been unable to steadily control interest rates. While the rate of inflation may be curbing, the interest rates have never taken any continuous climb downward. Despite all the talk of economic

recovery, the American people will never be able to attain affordable housing, automobiles and consumer credit until interest rates go down. Additionally, until interest rates come down, the economy will be unable to create jobs and employees of those industries dependent on the consumer's ability to attain credit will be laid off. We will never have real economic recovery until we are able to put a clamp on interest rates and put people back to work.

The trend at the national level is increasingly toward federal regulation of interest rates. Already in existence are federal laws that regulate other aspects of the loan industry, such as criminal loansharking and disclosure, which have withstood scrutiny under the commerce clause.[1] Loans and interest rates can no longer be considered purely a state phenomena anymore than loansharking is, and thus the reality of a viable national economy should enable federal legislation to be considered. We must not allow the current trend in state legislatures of relaxing usury laws to continue.

If this trend continues more and more persons, typically low and middle income families, will be forced out of the credit market altogether. There is indeed a great indication that legislation which would establish a universal usury ceiling should be enacted immediately.

[1] The Truth and Lending Act

H.R. 4572, The National Usury Act correctly addresses the issue of soaring interest rates. H.R. 4572 would establish a single, uniform nationwide usury rate; a maximum legal rate of interest that could be charged on most loans. Following a 36-month phase, this maximum legal rate would then be 10%. This legal rate of interest would apply to all loans in excess of $300.00 (except for loans up to $2,500.00 made by credit unions and petty loan companies and except on installment loans for periods up to five years and thirty-two days.)

One of the primary benefits of H.R. 4572 is that it would give money markets something they could count on. The bill outlines a schedule of interest ceilings that could put some certainty into the market. H.R. 4572 would give the money market something on which to base long term plans and committments with confidence.

Another important benefit of the bill is that it would reduce the deficit. Each one percent reduction in the interest rate would reduce the deficit over $2 billion in FY 1982, $5 billion in FY 1983, and $6.4 billion in FY 1984.

High interest rates are a major cause of unemployment. H.R. 4572, by reducing the interest rate would in effect also reduce unemployment. Additionally, each percentage increase in unemployment adds nine billion dollars to federal outlays and reduces federal income about twenty

billion dollars.

Finally, the schedule in H.R. 4572 for reducing the maximum rate of interest allowable would maintain a steady downward pressure on interest rates but would in no way preclude a faster decrease in rates through normal market forces--a decrease forseen by many economists. In effect, the bill would take the forecasts of declining interest rates and make them a "guarantee" instead of a "guess."

The gradual increase in interest ceilings will insure steadily declining interest rates. This guarantee in turn would be a major step toward facilitating long range planning in both financial institutions and industry.

I cannot stress enough how critical it is to enact federal legislation aimed at curbing interest rates. The health of our economy depends to a large extent on the course of interest rates.

Managing the economy is a federal function, for better or worse, and ought not be infringed upon, albeit indirectly, by the states. Those areas of usury legislation that states concern themselves with should be redefined. Any legislation, whether federal or state, should give proper attention to the long-term effect and

the undue burden that uncontrolled interest rates will have on the economy, industry and most importantly the consumer.

The issue of interest rates should be addressed by Federal legislation that will positively as well as effectively improve our economic forecast, and not legislation of piety to times and conditions that have long passed. Toward this end, it it my hope that this Subcommittee will act favorably on H.R. 4572.

Chairman FAUNTROY. I thank you, Mr. Stokes for your arguments for the passage of legislation of this nature. Among this legislation before us is a bill to impose a 10-percent usury ceiling on loans, and I wonder whether or not this ceiling would apply to interest rates on deposits as well. After all, a deposit is, in effect, a loan to a bank or other financial institution.

Mr. SNYDER. Mr. Chairman, it does not apply by wording of the legislation, but there is no question but what the pressure on what the bank or lending institution could charge would put them in a position where they would have to pay something less in order to have their spread.

Usury laws, when they were basically uniform across the land, in the States, I never ran across one on what the bank could pay for the money they borrowed, but the practical effect is, yes, it would bring down what the depositor would get virtually just by the economics of the situation. They would have to pay less than what they can get for it in order to stay in business.

Mr. COYNE. Mr. Chairman, may I follow up on that question?

I am curious if there would be any restrictions on investors here in the United States from putting their money in foreign deposits outside the country. Obviously, with the domestic market constrained, you would see a flight of capital to higher paying interest.

Mr. SNYDER. This is one argument that has been raised by some who might oppose the legislation. There is no prohibition in the legislation as written against sending money out of the country, so to speak.

I don't think that is a problem so long as you do not depress it artifically low, and we do not believe these numbers are artificially low. We are wedded to the principle, not the numbers.

At the present time, our interest rates are basically some of the highest in the world. Japan has a national usury law, which I believe is 10 percent. We don't see all their money coming over here. I don't believe that is a problem unless you go artifically low.

Mr. COYNE. Mexico has interest rates three times lower than ours.

Mr. SNYDER. I don't know anybody that wants to send their money to Mexico.

Mr. PERKINS. That is just a subterfuge. We are leaders of the world today, and we are going to be second- or third-class, if we don't do something about this problem.

Mr. SNYDER. The European countries are begging us to bring interest rates down, particularly Germany.

Chairman FAUNTROY. If the gentleman from the District may reclaim his time?

Mr. TAYLOR. In answer to Mr. Coyne's question, I rode out to Washington about 3 weeks ago with an industrialist from Houston, Tex., and was visiting with him. He was on his way to London to close a negotiated loan that his company had made with a bank in London, England, for 11½ percent, because he was unable to get anything close to that in this country.

So, I don't think we are out of line, and I don't believe that these people are going to run south with their money, or go overseas with their money; and, if they do, we can go back to the attitude of Andrew Jackson and Theodore Roosevelt, you know. We can control this thing if we want to do it. I don't believe we can relinquish our responsibility as Members of the Congress to let this usurious situation to continue in this country, that is wreaking havoc on every single American, on every business, agriculture, or every facet of our Nation's economy.

It is our responsibility, our duty, and we need to get about the Lord's business.

Mr. SNYDER. We did not have any problem with this when we had the uniform State usury laws.

Chairman FAUNTROY. Gentlemen, let me proceed with a couple more questions, and hopefully you can return after the vote.

Inflation is now less than 10 percent, but in the recent past it has been well above 10 percent, and it is not inconceivable that it could again enter the double-digit area, especially if there were an oil shortage.

If your bills were to become law, the interest rates could be no higher 36 months from now than 10 percent. How would you answer the question that if the value of your money were declining by more than 10 percent a year, would you want to receive only 10 percent on any money you were saving?

If you were lending money in those circumstances, would you want to receive less than a decline in the worth of your dollar?

Mr. SNYDER. That is a difficult question to answer, and it is one that is obviously pertinent to the discussion, but I don't know of anything that we could do that would be more compelling to keep inflation down than this action because of the built-in cost on everything that comes from the borrowed money that has to go into it.

If, in fact, we got to that point where it became necessary to take a look at the legislation, of course, the Congress would have to do that.

I do not foresee it as a problem. When you got so much money, you are going to lend it at the maximum you can get for it. I don't know what else you are going to do with it other than putting it in productive things which would be even better than saving it.

Mr. TAYLOR. The most inflationary thing that we have in this country today is high interest. I was a former automobile dealer when I came here, and I know what my floor plan was, and I know that when I set the cars out on the lot, I had to add an average of about $300 a car; so that is passed on to the customer.

General Motors, Ford, borrow money, and they add it onto the cost of the product.

Our Secretary of Treasury said on various instances: when we get inflation down, interest rates will come down to 3 or 4 percent above the inflation rate. I have heard many say it time and time again. I don't think it is going to happen. I don't think the big banks are going to let it happen, and for us to say that we can control inflation by high interest rates is kind of foolish, saying you can control the nosebleed by cutting the man's head off.

Mr. PERKINS. Controlling inflation by high interest rates is the craziest argument in the world.

How are you going to pass the costs on? Just think about it.

For years here, the Federal Reserve testified that we need interest rates only 1 or 2 points above inflation. If you go back in your old records, you see they changed that theme here about 1979, and what they are doing is bringing about more inflation, tremendously more inflation, and they are creating the greatest deficits in the history of the country by these high interest rates.

If it ever got to the point when we needed some controls, we could cut back some on the supply of money without increasing interest rates.

We have done that. We did that during the Truman administration. He controlled the situation without any problems, and he did it successfully. I hate to see this interest situation go on when it is adding up to more inflation, and that is all it is doing.

Mr. SNYDER. When we had the uniform State usury laws, the Feds required the banks to have more reserves, and, as a consequence, kept down inflation below what the lending rate was.

Mr. HUBBARD. Mr. Chairman, will you yield?

I may not be able to return, and I wish to express my appreciation to these five outstanding members who have encouraged us to pass this legislation. I certainly hope we can consider a markup of this House bill, 4572, in the very near future, Mr. Chairman, and vote it out of our full Banking Committee.

Mr. PERKINS. Let me thank my colleague from Kentucky and thank all of you for giving us this hearing this morning.

I see, when I go in my office down in Kentucky—people come in there in the coal business, and it is high interest rates that has broken them.

I would like for some of you gentlemen who don't see the thing the way I do, just to come down. All of you will readily jump on the bandwagon, and I am of the opinion that it is not only restricted to the Appalachian area. It is everywhere. Volcker-and-company, they care less about the little industries in this country than anyone. He just does not care for humanity, that man.

[Off the record.]

Chairman FAUNTROY. A number of the subcommittee members have indicated to me that they have a number of questions for our panel. In light of the current vote on the House floor number of

legislative votes that I expect will be taken today, I would ask that our distinguished panel return at a later date so that the members of the subcommittee can continue our dialog. Hearing no objection, we will schedule a date when we return from recess.

[Whereupon, at 12:05 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

[The following additional material was submitted for inclusion in the record.]

Southern Legislative Conference
of
The Council of State Governments

Conference Executive Director
Tom E. Richter
Southern Office, CSG
Suite 610, 3384 Peachtree Road, N.E.
Atlanta, Georgia 30326
(404) 266-1271

1981-82 Conference Chairman
Representative John E. Miller
House Majority Leader
Room 315, State Capitol
Little Rock, Arkansas 72201
(501) 368-4311

August 17, 1982

Honorable Walter E. Fauntroy
Chairman, Subcommittee on Domestic
Monetary Policy
2nd and D Street, SW
Room H2-109
Washington, D.C. 20515

Dear Representative Fauntroy:

Enclosed is a copy of a policy position of the Southern Legislative Conference regarding preemption of state usury laws. This position was adopted by the Southern Legislative Conference Consumer Protection Committee and was sent by mail to the Southern Legislative Conference Executive Committee under our current procedure for emergency adoption of policy positions.

Under this emergency procedure, if a position is deemed by a standing committee to be of such nature that action needs to be taken prior to the next meeting of our executive committee, the resolution is sent to all members of the executive committee and the standing committee. If a majority of the committee's members does not respond in the negative within 14 days, the resolution becomes a policy of the conference.

Therefore, although the attached resolution has not been openly debated by the Southern Legislative Conference Executive Committee, it is a policy of the Southern Legislative Conference. On behalf of the Southern Legislative Conference, I ask that this letter and the attached policy position be made a part of the record of your hearing.

Sincerely,

John E. Miller

Rep. John E. Miller
House Majority Leader, Arkansas
Conference Chairman

JEM
Enclosure

PREEMPTION OF STATE USURY LAWS

Proposed by Southern Legislative Conference Consumer Protection Committee on May 7, 1982; adopted by Southern Legislative Conference Executive Committee on May 28, 1982

WHEREAS, it has long been recognized that usury laws fall within the police power of the state and exist to protect the general welfare of the citizens of the state, GRIFFIN V. CONNECTICUT, 218 U.S. 563 (1910); and

WHEREAS, legislation is now pending in Congress which would, among other things, preempt state laws limiting the nature, rate, amount or manner in which interest, finance charges or other fees may be charged; and

WHEREAS, heretofore state regulation of consumer credit rate ceilings has been recognized as a proper subject of state legislation and has received express Congressional recognition, 15 U.S.C. Section 1610(b) [Truth in Lending]; and

WHEREAS, state officials have acted and will continue to act to adjust interest rate limitations where necessary to meet changing economic conditions and to reconcile the needs of credit extenders and consumers; and

WHEREAS, consumer credit rates, levels of competition and the existence, or non-existence, of competitive markets are questions best suited for resolution by state officials under settled, traditional principles of federalism.

NOW, THEREFORE, BE IT RESOLVED that the Southern Legislative Conference urge the United States Congress ot reject any legislation that would preempt any state statute or regulation concerning consumer credit rate ceilings or associated consumer protection measures; and

BE IT FURTHER RESOLVED that copies of this resolution be transmitted to all members of the Congress and to the President of the United States.

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TO AUTHORIZE A NATIONAL USURY CEILING

TUESDAY, SEPTEMBER 28, 1982

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 2222, Rayburn House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Representatives Fauntroy and Hansen.

Chairman FAUNTROY. The subcommittee will come to order and resume its hearing.

We will now take testimony from a number of public witnesses on the efficacy of a national usury ceiling. In my letter of invitation, I noted that proposals have ranged from those which would have the Federal Reserve impose a national usury ceiling, authorize the President to set a national debt, establish an index to control interest rates, establish a congressionally set discount rate, or direct the Federal Reserve to variously target interest rates in setting monetary policy. In extending to each of you the invitation to testify, I wanted to hear what you think proposals such as these might have on productive lending, speculative borrowing, the flow of funds, the present liquidity crisis, the volatility in interest rate movements, or the vitality of certain sectors. Other matters I hope you will touch upon include the impact on capital formation, the health of financial institutions, pensions, and foreign capital markets. I would also like you to comment upon the impact such proposals would have on the current trend toward deregulation.

Most importantly, I would like your assessment of whether or not a national usury ceiling would actually make additional credit available to borrowers or whether new forms of creative financing would occur to circumvent the established rate. Credit is the lifeblood of our economic system. Overly expensive credit, unavailable credit, and overly conditioned and contingent credit have devastating effects on business, employment, and productivity. While interest rates may now be falling, they are still too high. Any proposal that offers hope for lowered rates must, therefore, be given serious consideration. To some of our witnesses, these proposals may seem a bit different. It is true that they may be fraught with problems; but, they are also the symbols of hope to the many people who want us—expect us—to examine them with the view of ascertaining whether there is any way we can make them work.

[A notice of the subcommittee hearing, dated September 13, 1982, was submitted for inclusion in the record at this point:]

WALTER E. FAUNTROY, D.C., CHAIRMAN

PARREN J. MITCHELL, MD.
STEPHEN L. NEAL, N.C.
DOUG BARNARD, JR., GA.
HENRY S. REUSS, WIS.
JAMES J. BLANCHARD, MICH.
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BILL PATMAN, TEX.

HB-179, ANNEX NO. 2
WASHINGTON, D.C. 20515
(202) 225-7315

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JAMES K. COYNE, PA.

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
NINETY-SEVENTH CONGRESS
WASHINGTON, D.C. 20515

NOTICE OF SUBCOMMITTEE HEARING — September 13, 1982

To : Members, Subcommittee on Domestic Monetary Policy
Members, Committee on Banking, Finance and Urban Affairs

From : Walter E. Fauntroy, Subcommittee Chairman

Re : Additional Hearings on National Usury Ceiling Legislation

TUESDAY
SEPTEMBER 28

2128 RAYBURN
10:00 a.m.

The Subcommittee on Domestic Monetary Policy has already held one day of hearings on various proposals which would authorize some form of national usury ceiling. That hearing, which was held on Thursday, August 19, 1982, took testimony from Members of Congress who have proposed various bills. This additional day of hearings will conclude the questions and answers that Members of the Subcommittee were unable to pose to those Members who had sponsored legislation. This hearing will be held on Tuesday, September 28, 1982, at 10:00 a.m. in 2128 Rayburn House Office Building.

Additionally, the Subcommittee will take testimony from various trade groups who have expressed an interest in being heard on this subject. For further explanation of these hearings, please refer to the Subcommittee hearing notice of August 18, 1982.

Following is a list of bills which advance one or more of the propositions which postulate some form of national usury ceiling:

H.R. 4471 - National Usury Act: a bill to provide that no person may charge interest at a rate which is greater than 10% per annum on loans exceeding $300 and for other purposes.

H.R. 4572 - National Usury Act: a bill to provide that no person may charge interest at a rate which is greater than 10% per annum on loans exceeding $300 and for other purposes.

H.R. 4826 - Interest Rate Reform Act of 1981: a bill to reduct interest rates by limiting the rate of interest which the United States Government may pay on debt obligations issued by the United States and by establishing a national indexed usury ceiling.

H.R. 5066 - Federal Reserve System Reform Act: a bill to amend the Federal Reserve Act to provide for the increased responsiveness and accountability of the Federal Reserve System to Congress and citizens, to amend the Congressional Budget Act of 1974 to PROVIDE FOR THE ESTABLISHMENT OF ANNUAL DISCOUNT RATES, INTEREST RATES, and monetary growth rate targets, and for other purposes.

H.R. 6512 - Interest Rate Reduction Act of 1982: a bill to reduce interest rates by limiting the rate of interest which the United States Government may pay on debt obligations issued by the United States and by establishing a national indexed usury ceiling.

Chairman FAUNTROY. We look forward to the testimony of those whose work and experiences are in the financial and business sector. Kenneth Larkin, James Christian, John Kalchbrenner, Richard Rahn, James Hacking, and Thomas Durkin, we welcome you and eagerly await your testimony.

We are very pleased to have the first panel composed of Mr. Kenneth Larkin, executive vice president, Bank of America, representing the Consumer Bankers Association; Mr. James W. Christian, chief economist with the United States League of Savings Associations; and John H. Kalchbrenner, senior vice president and chief economist, Shawmut Bank of Boston, representing the American Bankers Association. Thank you so very much, gentlemen. And we are eagerly awaiting your testimony in whatever manner you may choose to present it. We have your prepared statements. Mr. Larkin, if you would begin.

STATEMENT OF KENNETH LARKIN, EXECUTIVE VICE PRESIDENT, BANK OF AMERICA, ON BEHALF OF THE CONSUMER BANKERS ASSOCIATION

Mr. LARKIN. Thank you. I am Kenneth Larkin, executive vice president of Bank of America and a member of the Government Relations Committee of the Consumer Bankers Association. The members of CBA presently hold 70 percent of all consumer credit outstanding held by commercial banks. As you probably know, commercial banks hold almost half of all installment credit outstanding in the United States today.

We are present today in response to a request by Representative Walter E. Fauntroy, chairman of the Subcommittee on Domestic Monetary Policy to present our views on a range of proposed bills to impose a national interest rate ceiling. In this connection, we have been asked to address a broad series of issues related to the imposition of any such rate ceilings.

These issues are of such variety and complexity as to severely tax the capacities of the world's leading financiers and monetary economists and would, I fear, certainly lead to substantial differences between them. The differences would arise not so much from their general disdain for such artificial restraints as usury ceilings, but rather as to the degree of economic calamity that would result from such rate impositions.

However, since "fools rush in where angels fear to tread," we have put together a 34-page statement which addresses most of the issues Chairman Fauntroy has suggested we consider.

Rather than tax your patience and outstay my welcome by reading our complete statement of 34 pages, I would like to take a few moments of your time to highlight the views expressed in our prepared statement and share a few personal observances and a few statements from widely respected economists.

I would like to examine the word "usury," itself, which is in itself a paradox. In Biblical times, the sin of usury came about when you received any payment, however small, for the use of money. Under that definition were I to loan you or anyone else $1 million at 1 percent, I would be a sinner, pure and simple. Since this concept was flagrantly unreasonable, it was flagrantly violat-

ed. So by the 16th century credit began to be widely used and usury became defined as the taking of excessive interest, whatever the term "excessive" means, rather than the taking of any interest. It is interesting to note, as did the National Commission on Consumer Finance in its 1972 report, which has remained the definitive text on consumer credit, that it was not until 1950 that Pope Pius XII declared that "bankers earned their livelihood honorably," and that was only 20 to 30 years ago.

I bring these matters up because whether we like it or not religion, economics, politics, and commonsense—or lack thereof—have all entered into the emotional aura surrounding the subject of usury.

I would also quote from that same report of the National Commission on Consumer Finance this statement attributed to the eminent economist Milton Friedman:

> I know of no economist of any standing who has favored a legal limit on the rate of interest that borrowers could pay or lenders receive—though there must have been some—Bentham's explanation of the "mischief of the antiusurious laws" is also as valid today as when he wrote that these laws preclude "many people, altogether, from getting the money they stand in need of, to answer their respective exigencies." For still others they render "the terms so much the worse . . . . While out of loving-kindness, or whatsoever motive, the law precludes a man from borrowing, upon terms, which it (the law) deems too disadvantageous, it does not preclude him from selling, upon any terms, however disadvantageous." His conclusion: the sole tenency of the law is to heap distress upon distress.

The chapter on "Rate Ceilings" of this same epic of the NCCC ends with this conclusion:

> On the basis of a summary of the historical approach to the establishment of rate ceilings and institutional knowledge about them the Commission must conclude that on balance, rate ceilings are undesirable when markets are reasonably competitive. Imposition of rate ceilings on consumer credit transactions neither assure that most consumers will pay a fair price for the use of credit nor prevents overburdening them with excessive debt. The public utility approach to rate making in the field of consumer credit is neither theoretically sound nor feasible although it can serve as a reminder that the legislators must recognize the relationship between costs and credit sizes if they do set ceilings.

Chairman Fauntroy suggests in his opening remarks, the proposed bills being considered by this subcommittee fly in the face of a determined wave of deregulation, a wave put in motion by consumers whose attitudes are best illustrated by that quote from the motion picture "Network" which touches a raw nerve in the citizenry: "We're mad as hell and we're not going to take it anymore."

For the past decade, both industry and government have been moving, however slowly, toward deregulation of the financial marketplace. Imposition of a national usury ceiling would be a complete reversal of this 10-year end. In 1980, Congress preempted usury ceilings on agricultural, business and mortgage lending. This action demonstrates the congressional recognition that usury limits represent an imposition of arbitrary governmental price controls on a commodity, money, makes no sense today.

More important than the fact that a national usury statute would be a backward move, and that it has, for good and valid reason, been disdained by many other countries, let's return to the concept of the price of money. A flat usury rate of, say, 10 percent puts an absolute limit on the rate that may be charged a consumer or perhaps, even the U.S. Government. Does Congress also propose

to put a limit on what financial institutions and others may pay to buy funds from consumers and businesses in order to loan these funds to other consumers and businesses? The DIDC is under constant and increasing pressure to deregulate savings rates. Unregulated money funds running around $230 billion are presently paying around 10 percent and, as you know, have paid considerably more throughout the past year, perhaps as high as 15 or 16 percent. Would you force them to pay a maximum of, say, 5 or 6 percent?

Congress cannot establish a strict national usury limit without taking the steps necessary to impose equally strict limits on the rates paid depositors. Since the 1930's, depositors have been forced to subsidize the price that borrowers paid to use the funds depositors sold to financial institutions at a Government-imposed price ceiling, otherwise known as regulation Q. However, depositors have learned much about the marketplace in the last decade. This subcommittee must ask itself whether it is prepared to ask American savers to accept less for their money in order to reestablish this loan subsidy. This subcommittee must also ask itself whether it is prepared to hear the response.

What about the lending side of the equation; will you require that safe loans bear the same rate as somewhat risky loans? Will complex loans with heavy documentation or acquisition costs per dollar of loan bear the same rate as a simple signature loan?

Dr. Robert Johnson, an acknowledged expert in the field of consumer credit, has likened consumer credit rate ceilings to the concept of putting a price control on the price of a chicken but allowing the price of chickenfeed to soar untouched—and that ain't no chickenfeed.

We believe our statement adequately addresses the four basic arguments often used to support usury laws.

First, there is no effective competition in the credit industry so that termination of usury ceilings would result in radically higher credit costs. In view of what we have seen lately with the broadened powers of thrift associations and the emergency of Sears, Merrill Lynch, and Shearson American Express into the realm of interstate banking, a realm which banks have not been allowed into as yet, can anyone, including those done by the Federal Reserve, show the exact opposite to be the case.

Second, consumers are unsophisticated in credit matters and therefore unaware of credit cost. Not so. As pointed out in our 34-page statement, a 1978 study of California cardholders—conducted by the Federal Reserve Board—found that almost 80 percent knew the interest rate on their credit accounts. I wonder if 80 percent of the populace know who represents them at local government levels.

On closed end transactions, awareness of the annual percentage rate had risen from 14.5 to 54.5 percent in a 7-year period, according to this same study. The moral of this study, and I speak as a consumer credit banker with over 30 years of experience, your average consumer is a darn sight smarter than either the politician or the banker thinks he or she is.

Third, the limitation on the availability of credit, caused by usury limits, is a good social result since it prevents consumers from overextending themselves.

Not so. This is a quasi-religious and moralistic approach to an economic subject. It is another case of big brother—read U.S. Government—supposedly knowing what is best for each of us. Again my experience as a consumer credit banker indicates that the opposite is true. Some time ago, before really the first waves of recession really belted us, the American consumer began to "tighten up his or her belt" and rein in the tendency to buy on credit. In fact, when we discount the effect of inflation, the apparently startling increase of total installment credit from around $100 billion to slightly over $300 billion in 1980 boils down to a modest real increase of 26 percent—not 26 per year but 26 percent per decade. Would that our Government have been so well-controlled. Installment credit debt as a percentage of disposable income has changed very little during that decade. It is virtually the same now, if not less, as it has been for a number of years. I would further suggest that a moderate increase in our level of installment credit debt is essential to our recovery from the present recession.

Fourth, the final concern about loan sharks is patently fallacious and one that can best be answered by asking the question—since when have loan sharks been constrained by law and when have they ever concerned themselves with truth-in-lending regulations? Of far greater concern, from my viewpoint, is the schlock car, appliance or furniture dealer who puts an outrageous price on his product, makes outrageous claims about the product, in all probability makes his profit out of the downpayment and is therefore content with the usury ceiling whatever it is.

Conversely, it is clear from a variety of studies that below market rate ceilings drive borrowers from traditional credit markets to credit sources that present substantially greater risks, like a broken knee if you don't pay on time. The lower the rate ceiling, the greater the driving force toward illegal lending activities. The only effective method of preventing loan sharking is to allow access to legitimate credit markets, by permitting the free market to operate.

Furthermore, it is important for this subcommittee to consider the true impact of usury ceilings, and this to me is so important. The simple fact of life is that the first borrowers injured by the reduction in the supply of credit caused by usury limitations are the less affluent, less creditworthy consumers. I am not saying that they are not creditworthy. I am saying that they are less creditworthy. Therefore, absent a conclusion that deprivation is the equivalent of protection, the end result is that those who are the intended beneficiaries of usury laws are, in fact, the individuals most adversely affected by them.

Usury ceilings have disastrous effects on housing and small business. As usury ceilings become generally binding at a below market rate, consumers seeking mortages generally will not be able to find them. Both Fannie Mae and Freddie Mac have stated that they are hindered in the secondary mortgage market by State usury ceilings. The imposition of a strict Federal usury ceiling will expand

the scope of the present problem by destroying the secondary mortgage market nationally.

Artificial constraints placed on the pricing of credit adversely impact small business both directly and indirectly. Small business feels any credit crunch first and most severely since they do not have access to equity markets and to many sources of debt capital, such as the bond and commercial paper markets. Small businesses are also injured when their potential customers can no longer obtain credit from third party lenders.

The current liquidity crisis for the Nation's thrifts and, to a lesser extent, the Nation's community banks, results from the negative spread between low-yielding mortgage portfolios and the costs of funds. Thrifts and banks must be able to earn market rates of return on loans to remain viable.

To sum up, gentlemen, there is an answer to the high-interest rates paid for loans today and the high rates financial institutions must pay to attract funds. However, you will not find it in the legislation under discussion today. You will find it when Congress gathers within itself the will and determination to live within its means, to match expenses with revenues. Only then will inflation retreat to moderate proportions, on a sustained basis, loan rates will decline and savers will be content with lesser returns and perhaps turn to capital formation in the business arena rather than merely earning money on money, such as interest on deposits, money funds, et al. This country is not in need of a Band-Aid; it needs a triple bypass.

Chairman FAUNTROY. Thank you, Mr. Larkin. Let me also say that your full statement in its entirety will be entered into the record. We look forward to raising some questions with you once we have heard from the others on this panel.

[The prepared statement of Mr. Larkin, on behalf of the Consumer Bankers Association, follows:]

, TESTIMONY OF

THE CONSUMER BANKERS ASSOCIATION

I am Kenneth Larkin, Executive Vice President of Bank of America, and a member of the Government Relations Committee of the Consumer Bankers Association.[1/] I appreciate the opportunity to appear before this Subcommittee to discuss the important issues relating to the imposition of national usury limitations.

For the past year, I have served as a member of the Retail Credit Advisory Committee of the State of California, appointed by Governor Brown. The mandate of the Advisory Committee was to investigate the costs of supplying credit to California consumers and to determine the desirability of imposing interest rate ceilings on consumer credit transactions. During the course of this investigation, the Advisory Committee considered many of the same issues facing this Subcommittee. After a detailed review, the Committee recommended, in its majority report, that the California legislature remove all statutory interest rate ceilings on retail credit sales in California.

The Association understands that members of the House of Representatives have proposed, in bills being considered by this Subcommittee, the adoption of a national interest rate ceiling. While we recognize and understand

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1/ The Association is a nonprofit organization that was organized in October 1919 to provide a voice for the retail banking industry. Since that time, the membership of the Association has grown to over 500 commercial banks of all sizes that are actively engaged in extending consumer credit. Combined, the members of the Association now hold over 70% of all consumer credit outstandings held by commercial banks.

the concerns giving rise to the proposals, the Association must respectfully urge its opposition to any such interest rate ceiling. In fact, it is our strong belief that the proposals before the Subcommittee are the exact opposite of the Congressional action that is needed at this juncture; that is, federal pre-emption of all state usury laws. For the past decade, both industry and government have been moving, however slowly, towards deregulation of the financial marketplace. Imposition of a national usury ceiling would be a complete reversal of this 10-year trend.

In 1972, the National Commission on Consumer Finance found

> "[O]n balance, rate ceilings are undesirable when markets are reasonably competitive. Imposition of rate ceilings on consumer credit transactions neither assures that most consumers will pay a fair price for the use of credit nor prevents overburdening them with excessive debt."

Since the National Commission released its report, many states have relaxed or eliminated their interest rate ceilings relating to a broad range of consumer and business transactions.

The Association has taken every opportunity during this same period to provide to Congress our analyses regarding governmentally imposed interest rate ceilings. We have analyzed the problems caused by interest rate ceilings; the lack of continued economic justification for such ceilings; the economic and other disruptions that have been

caused by these provisions; and the very real ways in which they negatively affect the very consumers and businesses that they are said to protect. We have urged that federal preemption of state usury laws is not only appropriate, but essential.

In 1980, Congress pre-empted usury ceilings on agricultural, business and mortgage lending. This action demonstrates the Congressional recognition that usury limits represent an imposition of arbitrary governmental price controls on a commodity - money - that makes no sense today. In testimony today we will review reasons why we oppose usury ceilings, briefly examine the specific proposals before the Subcommittee and then address certain of the specific issues raised in your invitation to testify.

Arguments Used to Support Usury Ceilings are Wrong

Four general arguments are used to support usury laws. The first is that there is no effective competition in the credit industry, so that the termination of usury ceilings would result in radically high credit costs. The second justification is the fear that consumers are generally unsophisticated in credit matters and, therefore, are unaware of credit costs. This lack of sophistication, reflected by unawareness of credit costs, it is argued, will permit creditors to charge very high rates of interest if usury ceilings are eliminated. A third justification for the continuation of usury ceilings is that the limitation on the

availability of credit, which is caused by usury limits, is a good social result since it prevents consumers from "overextension" and saves them from the inevitable economic and social disruptions caused by overextensions, including litigation, foreclosures, bankruptcies and the like. A fourth is that usury laws are necessary to prevent loan-sharking.

All of these justifications for interest rate ceilings are based on unsupportable factual premises and none of the justifications has any relationship to contemporary American society.

A. The Market Is Not Overly Concentrated. There simply is no support for the assertion that the credit industry is overly concentrated. The credit market is composed of an enormously large number of credit sources. The new short-term lending programs being undertaken by credit unions, savings and loan associations and savings banks will cause a significant addition to the supply side of the lending equation. As a general matter, competition is being affected favorably by a developing credit industry. The Federal Reserve Board studied a number of firms and the degree of concentration in 213 Standard Metropolitan Statistical Areas and 233 county markets between 1966 and 1975. The conclusion reached by the Board was that more markets experienced structural changes that enhanced competition than changes that reduced it. In addition,

deregulation has provided an expanded opportunity for competition since the completion of this Federal Reserve study.

Competition in the credit industry can also be shown by looking at the experience in states with no usury limits or with very high usury limits. The National Commission on Consumer Finance confirmed in 1972 that actual rates tend to fall below the maximum usury rates when these maximum rate limits were in excess of the effective cost of providing "lendable" funds. Thus, from both a structural point of view and from an historical review of the experience in states not having usury limits, we find substantial evidence to indicate that the credit industry is competitive. It may, of course, be true that current below-market usury limits create the situation in which many creditors are charging the same rates. However, it is hardly fair for those favoring usury limits to employ a principal symptom of these limits, namely the existence of identical rates throughout the industry in a given state caused by below market ceilings, as a reason for the continuation of the limits.

Experience in my state of California confirms the existence of a competitive market. California for many years has had essentially no interest rate ceilings on consumer loans by financial institutions. The California market provides consumers with ample credit and a wide range of interest rates and fees charged by lenders. These

variations, hardly characteristic of a monopolistic situation, present consumers with alternative choices that can be identified through credit shopping. In addition, California rates, set by the market, have often stayed below the artificial ceiling rates set in other states.

The free market does operate to assure that consumers will pay a reasonable price for credit, as is the case with all other goods and services they purchase. The extensive experience in states with very high or no ceilings that confirms this conclusion is not refuted by one or two "horror" stories of excessive interest rates. If these cases do exist, it is essential to examine both the facts of these transactions and their frequency. The facts, for example, may indicate that the transactions involve a small dollar amount, a short term and uncertain creditworthiness on the part of the borrowers. Those factors may well combine to produce a transaction with a rate that may appear to be "high." The rate level, of course, is relative to these and other factors making it literally impossible to look at a specific rate -- in isolation of the factors surrounding a specific transaction -- and declare that it is "too high." The frequency question also must be explored to see whether the cases identified are typical or merely isolated deviations from the vast majority of the millions of credit transactions entered into each year. If there are in fact instances of actual abuse, they should be addressed individually on the basis of unconscionability, as is the practice in Canada and most of Western Europe.

Moreover, in analyzing competition, it is important to emphasize the anticompetitive impact of usury laws. The continued existence of usury laws discourages competitors from entering the credit market and may, therefore, encourage concentration. It is obvious that potential new entrants have little incentive to compete in the credit market when the rates they can charge are limited by artificial, governmentally imposed ceilings, while many of their costs are dictated by an unregulated free market. This is particularly true since many of these credit programs involve substantial start-up costs which must be recouped before even considering the question of ongoing profitability. In the current economic situation, potential market entrants face a high risk and small gain potential, due, in large part, to the existence of usury restrictions.

The conclusion that usury ceilings deter new entry into the credit market was reconfirmed once more in the final report of the Interagency Task Force on Thrift Institutions. That Task Force, established by the Depository Institutions Deregulation and Monetary Control Act, analyzed the impact of usury laws on the participation of thrifts in more diverse consumer lending markets. It concluded that these ceilings discourage, if not prevent, diversification. It seems to be of little benefit to provide institutions with expanded powers if usury limits effectively prevent their use.

In addition, in some credit areas usury laws, and efforts at avoiding them, may actually lead to greater market concentration. In the credit card area, for instance, some financial institutions in states with no or very high rate ceilings -- or having the economic resources to move to those states -- are purchasing the portfolios and programs of creditors that are located in low interest ceiling states. The purchasing institutions then market their programs into the low-rate states at rates set by the market that reflect their real costs. One of the results of these activities -- which merely reflect the logical workings of a free market -- is to reduce the number of competitors participating in these programs and, of course, consumers end up paying a market rate.

Furthermore, a national usury ceiling will not eliminate or even substantially reduce this practice, and may, in fact, actually magnify the impact. For example, a low-rate national usury ceiling would preclude lenders from recovering costs in other domestic geographical markets and force these lenders to divert funds into foreign investments which permit a higher rate of return. The problem would be particularly acute for smaller lenders that do not enjoy the same economics of scale as larger lenders or do not have ready access to the international markets.

B. Consumers Have A High Level Of Credit Cost Awareness. The argument that consumers are unaware of credit costs flies directly in the fact of extensive private and governmental studies indicating that the literally millions of dollars spent by the credit industry on Truth in Lending disclosures have produced results. One study of bank credit card users found that for every 100 respondents in 1969 who did not know the annual percentage rate, only 50 had a similar response 15 months after the Truth in Lending Act became effective.

This level of awareness has continued to grow. A 1978 study of California bank cardholders found that almost 80% of the sample knew the annual percentage rate. In a study conducted by the Federal Reserve Board, it was found that, between 1969 and 1977, the awareness of closed-end credit annual percentage rates increased from 14.5% to 54.5%. Awareness of rates for bank credit cards during the same period increased dramatically from 26.6% to 71.3%. Without question, these levels of awareness are adequate to assure rate competition among credit grantors.

Conversely, to the extent that usury ceilings preclude creditors from recovering their costs through interest charges, creditors must attempt to recoup these costs by other means. In many instances, these "lost" credit costs will become part of the costs of goods being sold. In other instances, financial institutions will have to recover these costs through the pricing of other services

provided to the market place. In either case, consumer awareness of the actual costs of credit must suffer as a result. Yet lenders must recover their costs, and realize a reasonable profit, if they are to offer credit services at all.

C. Consumers Are Not Overextended. A third argument used in support of usury limitations is that such limitations save consumers from overextending themselves. This "non-economic" argument for the imposition of usury ceilings is really just the current version of the traditional social and religious view of interest and lending itself as being evil. The argument that consumers have insatiable credit appetites that are being held in check by usury limitations is not supported by any empirical data. Indeed, this argument has been refuted by studies that show that there has been no real growth of credit outstandings when you take into consideration the rate of inflation. The fact that consumers are not "overborrowing" has also been shown by private studies that have used a variety of income statement and balance sheet approaches. More recently, consumers have shown substantial restraint in their use of credit in response to current high interest rates.

D. "Loan Sharks" are Not Deterred by Usury Laws. The final argument suggests that usury ceilings somehow deter loan shark activity. In the first place, it is highly unlikely that loan sharks are going to be greatly influenced by any form of legal constraints. There is absolutely no evidence whatsoever to indicate that they follow usury laws. On the contrary, all evidence demonstrates that usury laws hurt only legitimate credit grantors.

Similarly, the use of these laws as a mechanism to prosecute loan sharks is not needed since numerous state and federal laws currently provide criminal penalties. It is difficult to imagine a loan shark making Truth in Lending disclosures or meeting the duties imposed by the many other state and federal consumer credit protection statutes. Moreover, if the activity giving rise to concern is truly loansharking, Title II of the Consumer Credit Protection Act of 1968 currently proscribes that activity and imposes substantial penalties on those who violate the law in authorizing fines of up to $10,000, 20 years in prison or both.

Conversely, it is clear from a variety of studies that below market rate ceilings drive borrowers from traditional credit markets to credit sources that present substantially greater risks. The lower the rate ceiling, the greater the driving force toward illegal lending activities. The only effective method of preventing loan-

sharking is to allow access to legitimate credit markets, by permitting the free market to operate.

In summary, Mr. Chairman, the four arguments cited for usury laws are simply without foundation in today's society. As in other attempts at placing economic controls on our economy, governmental price controls do not produce benefits to the market or those it serves.

Usury Ceilings Do More Harm Than Good

Not only do artificial price controls fail to produce positive benefits, but they actually damage both the economy and the very consumers and businesses they are intended to protect.

A. Ceilings Limit Credit Availability. First, usury laws severely limit the availability of credit when the market rate for money exceeds the maximum rate set by the states. Testimony presented in the Senate Banking Committee last year demonstrates the problem.

A banker from Massachusetts testified that the maximum rate obtainable under Massachusetts law for open-end credit plans is 18% on the first $500 of the finance charge balance and 12% on the finance charge balance over $500. That works out to an effective rate of return of 12.33% for a customer with a $9,000 debt. Obviously, this rate of return results in a significant loss for the institution given today's costs of obtaining money (the cost of funds

for that banker's consumer lending area was 17.53% for the first quarter of 1981).

The problem is not that of one bank alone. Recent studies of major banks in Massachusetts provided vivid evidence of the problems produced by usury laws. Two consecutive studies of the bank card experience in Massachusetts were conducted by the respected firm of Peat, Marwick, Mitchell & Co. The studies analyzed bank credit card operations in 1979, before the dramatic increase in cost of funds took place, and again in 1980. While the 1979 study revealed heavy losses by banks in their credit card operations, it is abundantly clear that the rising cost of funds has been the chief cause of even more unprofitable results in 1980.

The studies revealed that the banks surveyed in 1979 lost $13.74 on each credit card account. By 1980, that amount had increased to $19.67. On a per transaction basis, each time a consumer used his or her bank credit card in 1979, the bank lost 81 cents. In 1980, the banks lost $1.23 on each credit card transaction. In 1979, the seven banks surveyed suffered a net before tax loss of $15 million on their credit card operations. The 1980 figures showed a total loss of $20.5 million, despite the imposition of membership fees by six of the seven banks surveyed which brought in $3.8 million in new revenues. The cost of funds needed to support the outstanding balances rose from $36 million in 1979 to $45.4 million in 1980. Thus, the overall

loss was not due to unique circumstances faced by any one of the banks surveyed. In fact, each of the banks surveyed suffered losses on its bank credit card program.

Given the cost calculations reflected in these studies, in order for the banks to break even, their cost of funds would have had to be 6.68% in 1979, and 7.2% in 1980. That break even point -- which does not include any profit or return -- reflects cost of funds levels that have not been available for several years.

Due to the value of these programs to their customers and to the bank's overall service package, many banks have continued to offer these programs. However, as these figures demonstrate, this practice cannot continue indefinitely. The losses being sustained in this area are obviously being passed on to consumers of other credit and noncredit bank services, creating yet another economic subsidy. Quite clearly -- in view of the current cost of funds and the governmentally-limited prices on credit services -- many banks facing this situation will have to reduce credit availability and will ultimately be forced to terminate this form of open-end credit plan. (Parenthetically, it is particularly troubling to our industry that Congress can propose a 10% national usury ceiling on a loan for a customer who has been able to earn a greater rate of return on his money market fund deposits).

The reduction in available credit has not been limited to open-end credit. As a direct result of usury

limitations, one major Pennsylvania bank has reduced installment loans by almost 37% between 1978 and 1980. During the same period that bank had to respond to usury limits by reducing the number of new open-end accounts by almost 50%.

The first borrowers injured by the reduction in the supply of credit caused by usury limitations are the less affluent consumers. Since the economic return of creditors is in large measure based on the risks of repayment, any reduction in the supply of money for lending will cause creditors to lower their risk factors for the funds actually lent. Accordingly, those consumers with lower credit ratings, lower incomes and a higher incidence of unemployment will almost certainly be the first to be excluded from the credit pool. Absent a conclusion that deprivation is the equivalent of protection, the end result is that those who are the intended beneficiaries of usury laws are, in fact, the individuals most adversely affected by them.

B. Ceilings Cause More General Economic Harm. A second harmful effect of usury ceilings is that the diversion and curtailment of credit can cause economic harm at a more general level. For example, a 1977 study of the Tennessee economy estimated that the state usury ceiling caused an annual loss in output of $150 million and the loss of 7,000 jobs.

Other examples of the substantial and adverse impacts of usury laws on the economy as a whole are shown by the experience of two major banks located in the state of Maryland. During 20 months in 1979-1980, one bank reduced its installment credit portfolio by nearly $80,000,000, a decrease of almost 30%. One result of this dramatic change forced by state usury laws was that 27 positions -- affecting about 20% of the personnel handling this type of loan -- were eliminated.

During the same period in response to the increase in cost of funds and to state usury limitations, a second bank reduced its consumer credit portfolio by $200 million. That constitutes a reduction of 25% of the total portfolio previously held by the bank. One of the direct results of this has been a reduction of 115 employees operating in that area, approximately 25% of the total number of employees involved in consumer credit.

In short, experience demonstrates that usury ceilings mean less credit, less credit means fewer purchases, fewer purchases means less production, and less production means fewer jobs. The impacts of credit ceilings are substantial and they are real.

c. Ceilings Cause Geographic Dislocations. Third, usury laws have given rise to geographical dislocations based on rational business decisions with respect to usury ceilings. As should be expected in a highly mobile society,

recent changes in certain state usury laws have produced positive responses from financial institutions large enough to deal with the substantial capital and set-up costs to move to these more favorable regulatory environments in order to provide services to customers and potential customers. For example, several banks, including the Maryland banks discussed above, have made the decision to relocate certain facilities in the state of Delaware in order to operate in a rate climate that would allow them to offer credit programs to potential customers at rates that are consistent with costs.

As discussed earlier, a national usury ceiling will not preclude such geographic dislocations. If lenders are prevented from recovering their costs from domestic geographic markets, they will be forced to divert funds into foreign investments which permit a higher rate of return. Alternatively, lenders would have to curtail their credit operations generally, thus forcing domestic borrowers in even greater numbers to the foreign capital markets.

D. Ceilings Also Cause Product Dislocation. Fourth, past attempts to deregulate price controls on money by lifting or changing some but not all usury ceilings have resulted in "product" dislocation similar to the geographic dislocation discussed above. Under the Depository Institutions Deregulation and Monetary Control Act, for instance, mortgage lending and business and agricultural

credit were afforded different treatment from that given to general consumer credit. Not surprisingly, creditors in low rate environments have sought to make profitable loans in certain of these areas rather than unprofitable loans subject to more severe ceilings. This inevitable channeling of funds is descriptive of credit allocation not by the market but by arbitrary governmental rate ceilings.

An example of this kind of product shifting is evident in Arkansas, with a 10% interest rate ceiling. A 1981 report found that Arkansas residents held significantly less cash credit (credit not obtained from dealers at point of sale or on credit cards) but significantly more point-of-sale credit than did residents of states with less restrictive usury ceilings. Retail credit is available when usury laws fall below market rates because retailers can pass on costs of credit above the usury limit by increasing the cost of the goods they sell. All consumers who buy such goods, for cash or for credit, are therefore subsidizing the below cost credit available to less risky customers.

Frankly, Mr. Chairman, even a national usury law will cause similar dislocation. The ingenuity of the marketplace will move money offshore, or find new ways to finance needed goods, all in an effort to obtain a fair rate of return.

E. <u>Governmental Intervention in the Credit Market is Ineffective</u>. These ill effects of usury ceilings highlight

the essential argument against usury ceilings: they simply are not effective. Historically, governmental intervention in credit matters has not worked and has caused more harm than good. One example involves attempts to replace the free market with government restrictions on the amount of interest being paid by financial institutions, commonly referred to as Regulation Q. During the past fifteen years, government controls on the amount of interest payable to depositors have created an ever-increasing divergence between what the law permits depository institutions to pay and a fair market return to consumers.

Not surprisingly, the market found ways to avoid these limitations. Money market mutual funds, like other quasi-financial institutions, have filled this gap and now hold in excess of $200 billion, up from less than $5 billion only five years ago. Price controls calculated to "help" an industry at the expense of the small saver have contributed significantly to its current problems of shrinking deposits.

As a result of this price control on the amount of interest that financial institutions can offer to their consumer depositors, it has been estimated that during 1981, small savers lost $25 billion in interest by maintaining their accounts at financial institutions subject to Regulation Q ceilings. Money market funds have been offering market rates of 10 to 15% on an available deposit of $1,000 while financial institutions can only offer 5¼ to 5½% on a passbook account.

It should also be noted that this form of price control has produced distortions of credit availability in small or medium-sized communities. Most money market funds invest consumer deposits they receive in large certificates of deposit offered by money center banks, or in government securities. Essentially, the funds are no longer available in many local communities to finance homes, automobile purchases, small businesses or local farmers. The Regulation Q debacle vividly demonstrates that the imposition of controls on the market only leads to a result contrary to that intended by the regulation, since the market will operate to circumvent these controls.

A second example is the imposition of credit controls in 1980. During the three and one half months of the Special Credit Restraint Program, the entire banking industry was faced with a confusing and costly array of regulations and questions and answers that attempted to apply a single regulation to an exceedingly diverse and complex credit industry. This sudden imposition of a highly complex and technical regulatory scheme was particularly difficult for small financial institutions to handle. These small institutions simply did not have the expertise or resources to obtain, analyze and follow the regulations and interpretative materials that defined the Program. Thus, although they were fully aware of the civil and criminal

penalties, these institutions were simply unable to deal with the complexity and cost placed upon them by the Program.

In part due to the uncertainties created, the Credit Restraint Program had the practical effect of substantially slowing credit availability throughout the market. Later studies indicated that despite efforts to "carve out" special areas in dire need of access to credit markets (such as automobile sales and housing), the overall effect was to shock creditors and borrowers alike into an across-the-board cutback of credit that negatively affected all sectors, including those that could ill-afford any cutback.

The damage to the financial system was difficult to quantify. One study, however, showed that the cost to the economy was substantial. According to that study, the brief four-month intervention of government into the credit market resulted in a loss in GNP of $23 billion, a loss of 300,000 man years in employment, a loss of 500,000 new car sales and a loss in building starts of 50,000 units. Clearly, the costs under this Credit Restraint Program substantially outweighed any real benefits realized.

Specific Proposals

The proposals before the Subcommittee fall into two basic categories: one would set a fixed, flat-rate usury ceiling for all loans (10% is the figure in the

proposals), and the other would index interest rates to the rates paid by the Federal Government. We believe that both approaches are equally harmful. Past experience has shown that flat-rate usury ceilings do not work, regardless of the level set. Countless studies record the problems spawned by the 10% Arkansas interest rate ceiling. However, higher rate ceilings can present similar dislocations. For many years the State of New York had a usury ceiling of 25%, which seemed to be safely above any reasonably projected commercial lending rate levels. In 1980, however, interest rates were reaching that level, and the New York legislature had to act to lift the ceiling in order to prevent chaos in one of the nation's largest commercial lending markets.

An indexed interest rate (especially a rate indexed to an artificially-imposed Treasury bill rate) while slightly more flexible than a flat rate, still represents an arbitrary restraint on the free market system. In our experience there is no index that accurately reflects the multitude of factors that must be included in pricing credit services. Indices tied to some indication of money costs ignore operating and other non-money expenses. Moreover, there is no index that will consistently provide a valid reflection of even the cost of funds. Given a competitive market, rates will reach their own level, and an artificial index impedes this mechanism.

Issues Raised in Invitation to Give Testimony

As a representative of the nation's retail bankers, we would like to comment on the following specific issues raised in the Chairman's invitation to testify today.

A. "Productive Lending vs. "Speculative Borrowing". We do not believe that it is possible or fair to brand any particular type of credit nonproductive. Furthermore, so characterizing any type of credit necessarily involves exceedingly difficult decisions that are better made by the marketplace than by government action. As in any market environment, of course, the market may operate in ways that to some, applying their own socioeconomic and philosophical values, seem inappropriate or "nonproductive."

It is fallacious, arbitrary and misguided to believe that usury ceilings help ease inflation-caused high rates of interest or place lendable funds in the "right place" to improve employment by prohibiting "unproductive" loans and channeling the funds to more "productive" uses. It is virtually impossible to define a productive loan without being arbitrary, subjective or unfair. Using credit for producing food, clothing and housing certainly is worthwhile, but what about using credit for ice cream, video tapes, designer jeans, and alcoholic beverages? Are these not productive as well? Even a basic crop, such as soy beans, could not be clearly categorized as "productive" if

there were a soy bean surplus in existence at the time. The whole issue of definition is fraught with value judgments.

Even if one were to accept the premise that "nonproductive" credit extensions exist, nowever, it is critical to weigh the nature and extent of the problem and its damage against the cost and damage caused by what may be perceived to be the cure. If there are elements within the exceedingly large and diverse credit market that permit funds to be allocated for purposes that some assert to be less than fully productive, what are the costs to the rest of the credit system to attempt to eliminate that situation?

Mr. Chairman, we earnestly believe that even if certain transactions take place which some argue are nonproductive, the damage to the overall credit system and the economy as a whole that could result from interfering with the market would be far more destructive than any relatively minor nonproductive deviations that the market might permit. If particular abuses are identified, they should be dealt with by specific administrative action not through pervasive legislation.

B. Effects of the Proposals on Housing and Small Business. In discussing the relationship of usury ceilings to the housing industry, the common misapprehension is that government-mandated ceilings will result in more mortgage loans and, thus, a stronger housing industry. The fact is, however, that as usury ceilings become generally binding at

a rate below that of the market, consumers seeking mortgages generally will not be able to find them, except to the extent that exemptions in the usury statutes permit such lending at a profitable level. With or without such exemptions, usury restrictions result in a decline in both housing construction and the ability of consumers to buy or sell existing homes. The impact on housing construction is particularly serious because of the nation's current housing needs and the effect on unemployment in the construction industry.

As a practical matter, lenders cannot and should not be expected to make mortgage loans at rates substantially below their cost of funds. To do so would raise questions regarding the soundness of the institution's lending practices. If market conditions drive lending costs to an unacceptable level, the answer is to address the market conditions and not to artificially restrict the rates of interest that may be charged in that marketplace.

An equally important aspect of mortgage related lending is the impact of interest rate ceilings on the activities of the secondary mortgage market. First, there can be no doubt as to the importance of the secondary mortgage market on the liquidity of both thrift institutions and commercial banks. Congress has attempted to encourage thrift institutions to diversify and shorten their asset structure by authorizing consumer lending. Nevertheless, the secondary mortgage market remains the primary vehicle for

converting 30-year home loans into "short term" assets by removing 80% to 95% of these assets from the books of the institutions entirely.

It is equally clear that the second mortgage has become increasingly important in home finance. The Department of Housing and Urban Development recently stated that one-fourth to one-half of all home sales in some states depend upon the availability of second mortgage finance. Thus, the two national secondary mortgage associations have developed programs to purchase second mortgage loans and home improvement loans from thrifts and commercial banks. Both the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation have stated, however, that they are hindered in their efforts by state usury ceilings. For example, the FHLMC has said that states with usury ceilings below market levels will not be able to originate loans with sufficient rates to cover their costs and meet the FHLMC program yields, which yields reflect the Mortgage Corporation's costs of borrowing funds in the capital markets plus its own costs of doing business. Financial institutions in such states, therefore, must either carry such below-market loans on their own books for full term or forego making such loans altogether. Neither option is acceptable in today's marketplace.

Furthermore, the imposition of a strict federal usury ceiling will merely expand the scope of the present problem by destroying the secondary mortgage nationally.

Some critics have argued that the removal of interest rate ceilings has crippled the housing industry by making mortgage loans less affordable. In fact, the imposition of a below-market national usury ceiling could eliminate mortgage loans entirely.

As to the impact of usury ceilings on other business activities, we strongly believe that such ceilings actually damage both the economy and the very consumers and businesses they are intended to protect. In point of fact, large commercial borrowers frequently have a broad range of options for meeting their financial needs. Many large corporations can obtain needed funds from the domestic equity markets or even from the foreign capital markets. It should come as no surprise, however, that small business organizations have special financing needs when compared to larger enterprises. For the most part, small firms are denied access to equity markets and do not have access to many sources of debt capital, such as the bond and commercial paper markets. As a result, small businesses rely to a great degree on commercial bank credit to meet their financing requirements. At the same time, smaller firms tend to be more highly leveraged than their large counterparts. As a result, it is often small business that feels any credit crunch first and most severely.

Artificial constraints placed on the pricing of credit adversely impact small businesses both directly and indirectly. First, as the costs of providing credit

increase, usury ceilings force lenders to divert funds to investments which permit a higher rate of return. When this occurs, small business organizations have difficulty raising the capital necessary to finance their activities. Usury ceilings like those in Arkansas, for example, when combined with high costs of funds, lead to staggering attrition rates among small businesses.

Furthermore, small businesses are also injured when their potential customers can no longer obtain credit from third party lenders. Small businesses are less able to shift their costs geographically or to subsidize these costs through other product or credit lines. Similarly, small business organizations that offer consumer credit themselves are unable to sell their consumer credit contracts in low ceiling markets to generate the funds necessary to pay vendors, employees and overhead costs. Thus, for example, both automobile dealers and retailers have been frustrated in their attempts to maintain sales and employment levels due in significant part to the inability of consumers to obtain financing. This problem can only be exacerbated by the imposition of strict national usury ceilings. Such national ceilings would preclude lenders from "exporting" credit from unregulated or high ceiling states and make it difficult for business organizations to shop for credit available in other states. Strict national ceilings would make credit equally unavailable in all domestic credit markets.

D. Effects of the Proposals on the Liquidity and Health of Financial Institutions. Everyone today is aware of the fragile liquidity position of the nation's thrift institutions and, to a lesser extent, many commercial banks. The current liquidity crisis results from the negative spread between low-yielding mortgage portfolios and the cost of funds driven to present heights by competition for deposits from quasi-financial institutions, like the money market funds, and by congressionally mandated deregulation of the ceilings on deposit rates. Thrifts must be able to earn market rates of return on loans to remain viable.

To assist thrifts to achieve their recovery, Congress has preempted mortgage usury ceilings and has expanded the permissible scope of thrift credit granting activities. However, as Chairman Pratt of the Federal Home Loan Bank Board has testified before the Senate Banking Committee, thrifts have been unable to use the new consumer lending authority granted to them in 1980, because present usury limitations in many states make consumer lending unprofitable. The effect of existing usury limitations is, therefore, to exacerbate the already critical problems of thrifts. Imposition of additional usury limits would make their situation intolerable.

In order to earn market returns on their lending operations, thrift institutions must be able to react to changing supply and demand conditions and to allocate credit

to its highest and best use. In addition, loan rates must be freely determined by market forces so that a continued misallocation of financial resources does not occur. Treasury Secretary Regan testified recently that the most pressing need at this time is for further decontrol of asset powers to better utilize the high cost of deposits that accompany deregulation. At the same time, it is essential to insure that the use of these expanded asset powers is not frustrated by the imposition of rate ceilings.

It is less widely recognized that a number of small and medium-sized commercial banks are in a financial condition similar to that of the thrifts. Many community banks have large portfolios of low-yielding mortgages and are facing severe liquidity problems. Lowering the rate of return on non-mortgage assets for these small banks could prove fatal. Banks and thrifts must be able to earn a market rate of return on their assets in order to maintain their liquidity. In particular, profitable consumer lending activities are critical to the viability of these institutions as liability deregulation proceeds.

Furthermore, it should be recognized that smaller financial institutions are disadvantaged by usury ceilings even more than larger lenders. Since the loan volume of small lenders is less, their break even point is frequently higher. Similarly, such institutions often take much longer to recover their start up costs and, thus, have more

difficulty meeting the changing demands of the market when encumbered with low interest rate limitations.

D. Effects on the Current Trend Towards Deregulation. As noted earlier in our testimony, the proposals before the Subcommittee represent a complete reversal of the efforts towards banking deregulations made over the past decade. For example, adoption of these proposals would reverse the action of Congress taken just two years ago to preempt many state usury ceilings. In addition, the imposition of national rate ceilings, such as those proposed, could make it economically impossible to continue the Congressionally mandated deregulation of the liabilities of financial institutions. The economic fact of life is not difficult to grasp -- financial institutions cannot continue to pay more while they are earning less and survive for very long.

The fundamental concept underlying financial institutions deregulation is the leveling of the competitive playing fields. Congress has determined that it is unprepared to regulate further the money market funds and other quasi-financial institutions. Therefore, it must deregulate traditional financial institutions if they are to retain their competitive vitality. This competitive vitality cannot be achieved, however, if gains on one side of the balance sheet are offset by losses on the other side. Similarly, domestic capital markets cannot continue to compete with foreign capital markets, if domestic lenders

are hamstrung by rate ceilings which preclude them from paying the market price for the deposit funds they need to compete.

A statute or regulation that deals with only one segment of a highly complex and interdependent economy, such as usury ceilings, will invariably cause disruptions within the economy and dislocations in favor of areas not subject to that statute or regulation. Such disruptions can only adversely effect the current deregulation efforts.

F. Effect on Depositors and Savers. Congress cannot establish a strict national usury limit without taking the steps necessary to impose equally strict limits on the interest rates paid to depositors. Similarly, if financial institutions are to survive ultimately, these same limits must be imposed on all entities competing for funds in the marketplace, whether those entities pursue funds through the payment of interest or dividends. If financial institutions can buy funds in the marketplace at 5%, they will be able in most instances to sell those funds economically at 10%. However, there will be comparatively few dollars to purchase in the marketplace at 5% if any purchaser is permitted to pay substantially more than 5% for the same dollars.

From the 1930's until recent times, depositors have been forced to accept a government-imposed price ceiling on the deposits they sold to financial institutions. As a result, these depositors have been forced to subsidize

the price that borrowers paid to use these same funds. However, depositors have learned much about the marketplace in the last decade. Particularly in metropolitan areas, depositors have become very rate conscious. At the same time, they have demonstrated an unwillingness to subsidize directly the lending needs of others. This Subcommittee must ask itself whether it is prepared to ask American savers to accept less for their money in order to reestablish this loan subsidy. This Subcommittee must also ask itself whether it is prepared to hear the response.

Conclusion

The growth of credit, and retail credit in particular, is vital to the overall economic health of the country. The legislation before this Subcommittee would stifle that growth. We must emphasize that usury ceilings are nothing more than price controls on a commodity -- money. As in other segments in our economy, the imposition of arbitrary price controls -- by whatever level of government -- is inconsistent with the proper and efficient operation of a free market economy. It is also inconsistent with the current trend towards deregulation in banking and other industries. And, quite simply, it does not work.

Once again, Mr. Chairman, thank you for providing the Consumer Bankers Association with the opportunity to present our views on this important issue.

Chairman FAUNTROY. We will now move to Mr. Christian.

STATEMENT OF JAMES W. CHRISTIAN, CHIEF ECONOMIST, UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS

Mr. CHRISTIAN. Thank you, Mr. Chairman.

My name is James Christian, I am chief economist of the United States League of Savings Associations. I appear before the subcommittee on behalf of the U.S. League and the more than 4,000 savings associations which it represents.

I will provide you with a brief oral statement at this point. You have, I believe, my written statement of somewhat greater length.

Chairman FAUNTROY. It will be inserted in the record in its entirety.

Mr. CHRISTIAN. Thank you, Mr. Chairman.

Mr. Chairman, usury laws that limit the rate of interest charged by lenders are in the nature of price controls. In economics, such controls can best be justified when the firm or firms to which the law applies has a monopoly position in the relevant market.

A firm that controls the supply of an essential good or service has extraordinary economic power which the public may legitimately choose to restrain by imposing regulatory controls over the prices that the monopoly firm may charge.

The regulatory pricing procedures applied to public utilities are prime examples of legitimate social intervention in the pricing decisions of private enterprises that hold monopoly positions in the marketplace.

Generally speaking, the laws of the United States prohibit monopoly in all cases except public utilities. Our laws also prohibit monopolistic pricing where two or more firms, neither of which has a monopoly position, conspire to set a monopolistic price. In short, as a Nation we have preferred to promote competition in pricing by prohibiting monopoly and monopolistic pricing rather than to allow monopoly and intervene directly in the pricing process.

Mr. Chairman, usury laws stand in contradiction to this general policy position. The credit markets today cannot be characterized as monopolistic. Indeed, they become more competitive every day. Even in local market areas, the international credit card, interstate finance companies, electronic funds transfer, overdraft privileges, and a variety of other institutional and technological devices have vastly broadened the opportunity for both consumers and businesses alike to shop for credit.

Truth-in-lending regulations and the provisions of the Equal Credit Opportunity Act also serve to standardize the information borrowers receive and minimize such deceptive or discriminatory lending practices as may have existed in the past.

Given, then, that credit markets are highly competitive today and that a variety of other laws regulate not only the structure but also the operating procedures of lending institutions, it is difficult to find either an economic or a social justification for usury laws. Indeed, there is a growing body of empirical evidence to indicate that usury laws work to the economic detriment of those they are ostensibly designed to protect.

In our written statement, Mr. Chairman, we have summarized a number of empirical studies that have investigated the effects of usury in both local and national markets. I will not attempt to go through any of those. But let me just summarize, if I may, the general conclusions that arise out of those studies.

These studies and others cited in the bibliography, also included in the statement, all point to the inefficient nature of usury laws. High-risk individuals are locked out of the market. Credit supply is diminished. Home construction is cut, non-price-rationing of credit becomes commonplace. Hence, from an economic viewpoint, usury laws really serve no useful purpose, in no way contribute to social welfare, but rather detract from it.

If I may depart briefly from my prepared statement, Mr. Chairman, I would like to note that essentially 10 years of my professional career were spent working abroad, consulting with ministries of finance in developing countries and helping them to develop housing finance systems. I have seen more than I care to remember of distortions in economic systems produced by laws similar to usury. And I would like to give you one brief example from my experience that may be helpful in this regard.

Mr. Larkin noted the Biblical concept of usury. The country from which I would like to draw the example was a Moslem country. I don't want to tell you which one it was. But those same traditions still prevail in the Middle East. That country was experiencing 20-percent inflation, more or less. They nevertheless had controls on what financial institutions could pay for deposits of 5 percent, and were limited to charging only 7 percent, for loans. Those rules had been in effect for some time without change. We were attempting to promote a housing finance system that could deal primarily with low-income people.

Every Government official that we dealt with assured us that low-income people could not pay more than 7 percent. We nevertheless did our own surveys in the informal sector of one of the largest cities in the world, and found that what was occurring was really a circumvention of the law.

We found a parallel market. We found an informal sector with informal financing procedures such as the following: Homes were being constructed by small contractors who did not charge interest, did not make loans to the customer.

Rather, they had a sliding scale of prices such that if you were prepared to pay cash, there was one price. If the homeowner wanted to take a year, there was a higher price. If he wanted to take 2 years, there was a still higher price, and so on. So that when you sorted that out and put it on an interest equivalent, you found that very poor people in the informal sector of the economy were paying 25 percent for 3- and 4-year money, in distinct contradiction to what Government officials believed that they could afford to pay.

They were, in fact, doing it, and this kind of situation was one in which if we had had the formal sector of the economy operating on rational terms we could have made those funds available to them at less than 25 percent. Those, I think, are the kinds of distortions that ultimately arise from the imposition of unrealistic and non-market-related controls on the economy.

Let me return to my prepared statement for a moment and just summarize what our research has indicated about usury in the United States as it present exists. As nearly as can be determined from secondary sources, only seven States do not currently impose limits of some kind on the rate of interest that may be charged. Seven more States impose limits on one or more loan categories that float with market interest rates and impose no limits on other loan categories. If limits on interest rates are deemed to be essential, this form of usury ceiling is clearly preferable to absolute limits that cannot respond to changes in market conditions without overt legislative action.

Nevertheless, 36 States and, I am sorry to say, your own District of Columbia, representing approximately 73 percent of the U.S. population, set absolute limits on the interest that can be charged on at least one loan category. In a few cases, these limits are high enough to be essentially irrelevant. If that is so, they serve no purpose. In other cases, however, the limits are low enough to be effective from time to time, particularly given our recent experience with high interest rates. In these cases, distortions in the allocation of credit are entirely possible.

Mr. Chairman, usury laws really have no useful purpose to perform in a modern economy such as ours. They belong to much earlier times, to Biblical days and the Middle Ages in Europe, when a loan request typically arose from distress, not from the need to carry out a useful and productive activity of benefit to the economy. National leadership may be necessary to bring State usury laws into harmony in the interests of promoting a more efficient allocation of credit. Such leadership should move in the direction of the elimination of usury ceilings; any suggestion that national usury laws be imposed that would establish absolute limits on interest rates should be rejected by the committee.

Thank you.

Chairman FAUNTROY. Thank you, Mr. Christian.

[The prepared statement of Mr. Christian, on behalf of the United States League of Savings Associations, follows:]

STATEMENT OF DR. JAMES W. CHRISTIAN

TO THE SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

OF THE COMMITTEE ON BANKING

OF THE UNITED STATES HOUSE OF REPRESENTATIVES

TUESDAY, SEPTEMBER 28, 1982

Mr. Chairman, my name is James W. Christian. I am Chief Economist of the U.S. League of Savings Associations. I appear before the Subcommittee on behalf of the U.S. League and the more than 4,000 savings associations which it represents.

Mr. Chairman, usury laws that limit the rate of interest charged by lenders are in the nature of price controls. In economics, such controls can best be justified when the firm or firms to which the law applies has a monopoly position in the relevant market. A firm that controls the supply of an essential good or service has extraordinary economic power which the public may legitimately choose to restrain by imposing regulatory controls over the prices that the monopoly firm may charge. The regulatory pricing procedures applied to public utilities are prime examples of legitimate social intervention in the pricing decisions of private enterprises that hold monopoly positions in the marketplace.

Generally speaking, the laws of the United States prohibit monopoly in all cases except public utilities. Our laws also prohibit monopolistic pricing where two or more firms, neither of which has a monopoly position, conspire to set a monopolistic price.

In short, as a nation we have preferred to promote competition in pricing by prohibiting monopoly and monopolistic pricing rather than to allow monopoly and intervene directly in the pricing process.

Usury laws stand in contradiction to this general policy position.

The credit markets today cannot be characterized as monopolistic. Indeed, they become more competitive every day. Even in local market areas, the international credit card, interstate finance companies, electronic funds transfer, overdraft privileges, and a variety of other institutional and technological devices have vastly broadened the opportunity for consumers and businesses alike to shop for credit. Truth-in-lending regulations and the provisions of the Equal Credit Opportunity Act also serve to standardize the information borrowers receive and minimize such deceptive or discriminatory lending practices as may have existed in the past.

Given, then, that credit markets are highly competitive today and that a variety of other laws regulate not only the structure but also the operating procedures of lending institutions, it is difficult to find either an economic or a social justification for usury laws.

Indeed, there is a growing body of empirical evidence to indicate that usury laws work to the economic detriment of those they are ostensibly designed to protect.

A study by Norman Bowsher (1974) produced many quantitative measures of the preserve influence of usury laws. The data are descriptive in nature, not inferential, but are very informative nonetheless.

Bowsher found that Mississippi and Missouri each had 8% usury ceilings on home mortgages. For the first four months of 1973 the FHA average rate on a 30-year mortgage was 7.62%. In the first four months of 1974, the FHA average was 8.78%. In these two states, residential construction was 34% lower in 1974 than in 1973 during corresponding periods. This compared with a 16% decrease in residential construction in the other states of the 8th Federal Reserve District and a 21% decrease nationwide. Other states in the 8th District had usury ceilings high enough so that they were not effective.

In contrast, nonresidential construction, which was exempt from the ceilings, rose 8% in Mississippi and Missouri and 9% in the other 8th District states. The national increase was 2%.

The study also found that savings associations in Missouri purchased more mortgages than they did a year earlier. The bulk of these purchases occurred in states that had usury ceilings sufficiently high so as not to cramp the market mechanism. Local mortgage loans declined markedly. The shift of funds outside the state was therefore pronounced.

Bowsher also notes that ways were found to circumvent the law. Loans were closed across state lines where more liberal laws existed. The effective rate on mortgages was increased by increasing the number of points charged to the seller, buyer, or both. Such methods "run risks of illegality, are inefficient, and probably cause effective rates to be slightly higher to the borrower and lower to the saver than they would be in a free market setting."*

A study by Robert Shay (1970) analyzed two questions empirically. First, do higher legal rate ceilings cause licensed small loan lenders to accept poorer credit risks? Second, do higher legal rate ceilings increase the availability of loans? The data base consisted of data gathered from 30 states on the consumer finance industry. The data produced evidence to answer the first question affirmatively. The answer to the second question was inconclusive.

The first question was answered by examining the correlation between two ratios. The ratio of average gross operating income to average loans outstanding was used as a proxy for the height of the legal rate ceiling inasmuch as most licensed lenders operating under state small loan laws charge the ceiling rate to borrowers. The ratio of provisions for bad debts to average loans outstanding was used as a proxy for the degree of credit risk accepted by a licensed lender.

A high positive correlation between these ratios would signify that higher rate ceilings would cause higher risk to be accepted by the lender. In a regression equation with the bad debt ratio as the dependent variable, Shay found that the only significant independent variable was the gross yield per dollar of average loans outstanding. Shay's result agree with earlier studies of Goudzwaard (1968) and Kawaja (1969). High-risk individuals can be excluded from the market if usury laws become effective.

With respect to the second question, Shay could not give a conclusive

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Norman M. Bowsher, "Usury Laws: Harmful When Effective," Review, Federal Reserve Bank of St. Louis, August 1974, p. 22.

answer. By dividing the state data according to the height of the rate ceilings, Shay had hoped to find a relationship between rate ceilings and the supply of loans. The results were inconclusive. Shay felt the main problem was that the data available were not sufficient to completely test his model. His model was one of imperfect competition.

A study done four years later, however, was able to answer the second question affirmatively. The study by Douglas Greer (1977) used data collected from 48 states (Alaska and Montana missing) by the National Commission on Consumer Finance in 1971. Greer was able to divide his data base into groups according to the type of usury laws on the books. Greer's division of the data supported Shay's claim of insufficient data in 1970. Greer found that of the 18 additional states in his base, 12 of them had very low usury ceilings where the effect of usury laws would be most pronounced.

With total personal loans extended or outstanding and number of loans per 1,000 families extended or outstanding as dependent variables, Greer found the legal rate ceiling to be an important independent variable. Dollar supplies tend to rise more rapidly than the number of loans made as the rate ceiling is increased.

Two other conclusions emerged from Greer's study. First, personal loan supplies were positively related to easy market entry and low market concentration. The theory that competition rather than regulation enhances supply is borne out. Greer found this to be particularly true in states with high rate ceilings, i.e., where the rate ceilings were ineffective and competition was allowed to rule. Secondly, Greer found

that diversity or variance in rates was positively associated with credit supplies, particularly in high ceiling states. Lenders in these states were able to obtain their risk premium for those high-risk borrowers. This was not true in states with low rate ceilings.

Two other studies worth mentioning are those of James Ostas (1976) and Phillip Robins (1974) dealing with the effects of usury laws on home construction and home mortgages.

Robins studied the effects of usury laws on single-family homebuilding in 77 Standard Metropolitan Statistical Areas (SMSA). With regression analysis, Robins used real per capita income, population levels, population growth, population density, housing prices and a dummy variable measuring the impact of low usury ceilings as independent variables to explain the number of single-family housing starts.

The results were striking. The level of housing starts in SMSAs with usury ceilings were 28% lower than those without usury laws in effect. Robins went on to conclude that usury laws have precisely the same effect as any other price ceiling. In addition, because the laws are not uniform, greater distortions are created. This causes regional differences in rates and shifting of credit funds in a non-optimal fashion.

Ostas tested two hypotheses: (1) usury laws cause rationing of credit by nonprice means and (2) usury laws result in diminished loan flows and residential construction. The rationale underlying the first hypothesis is that lenders will charge higher closing fees and demand higher downpayments in order to ration the low supply of funds caused by

usury laws. This is the only way for the lender to maximize profits. The second hypothesis is the same as that tested by Robins.

The data consisted of quarterly data over a five year period from 15 SMSAs. The dependent variable to test the first hypothesis was loan fees, measured by the difference between effective mortgage rates and contract rates. Loan flows, measured by housing permits authorized for the construction of single-unit dwellings, was the dependent variable for the second hypothesis. Other dependent variables tested were the loan-to-value ratio, mortgage term, and mortgage loan flow. Independent variables included equilibrium rates present without usury laws and regional and seasonal variables.

The estimated equations supported the hypotheses. There was a strong positive relationship between the size of loan fees and the amount by which market rates exceed usury limits. Results showed that a 1% difference between what lenders would like to charge and what the law permits them to charge caused the average permit volume to decrease by 19%. Compare this with Robins' result.

Ostas concluded that legal restrictions on contract rates for mortgages cause three forms of nonprice rationing: (1) higher loan fees, (2) higher downpayments and (3) shorter loan terms. The restrictions on rates reduced the incentive of the lender to make home mortgages. The result is reduced permit volume and residential construction.

These studies and others cited in the bibliography at the end of this statement all point to the inefficient nature of usury laws. High-risk individuals are locked out of the market. Credit supply is diminished.

Home construction is cut. Nonprice rationing of credit becomes commonplace. Hence, from an economic viewpoint, usury laws serve no useful purpose. They in no way contribute to social welfare, but rather, detract from it.

As nearly as can be determined from secondary sources, only seven states do not currently impose limits of some kind on the rate of interest that may be charged--Arizona, Illinois, New Hampshire, New Mexico, Oregon, South Dakota, and Virginia.

Seven more states impose limits on one or more loan categories that float with market interest rates and impose no limits on other loan categories. These states are California, Delaware, Montana, Nevada, North Dakota, Washington, and Wisconsin. If limits on interest rates are deemed to be essential, this form of usury ceiling is clearly preferable to absolute limits that cannot respond to changes in market conditions without overt legislative action.

Nevertheless, 36 states and the District of Columbia, representing approximately 73% of the U.S. population, set absolute limits on the interest that can be charged on at least one loan category.

In a few cases, these limits are high enough to be essentially irrelevant. If that is so, they serve no purpose. In other cases, however, the limits are low enough to be effective from time to time, given our recent experience with high interest rates. In these cases, distortions in the allocation of credit are entirely possible.

Mr. Chairman, usury laws really have no useful purpose to perform in a modern economy such as ours. They belong to much earlier times, to Biblical days and the Middle Ages in Europe, when a loan request typically arose from distress, not from the need to carry out a useful and productive activity of benefit to the economy.

National leadership may be necessary to bring state usury laws into harmony in the interests of promoting a more efficient allocation of credit. Such leadership should move in the direction of the elimination of usury ceilings; any suggestion that a national usury law be imposed that would establish absolute limits on interest rates should be rejected by this Committee.

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Chairman FAUNTROY. We now have been joined by the distinguished ranking member of the subcommittee, the gentleman from Idaho, Mr. Hansen. We are very pleased to have you join us.

Mr. HANSEN. Thank you, Mr. Chairman. And I appreciate your introducing my opening statement into the record in my absence.

There are about three committee meetings going on this morning. I came in on the all-night airplane from the West. That is one advantage you have living locally. You don't have to do those things. I apologize to the witnesses for being late. I will have to slip over to another Banking Subcommittee in a moment and be back, but I will study what you are saying and what you have submitted with great interest.

Although, Mr. Chairman, if you would indulge me for just one moment, I know that the usury ceiling is something that bothers any of us who think in terms of free exchange of commerce, money, and other things. It still, I think, is something that is well to discuss, because there is some reason to believe on the part of a great many people that even though we don't have legislation that imposes it directly, we have certain types of legislation to restrict interest rates to some degree, and maybe of the same effect in some regards.

We also have certain people in the private sector who have considerable amount of influence, as we discussed in the previous meeting, Mr. Chairman, that also in a sense can act in terms of interest control or ceilings or floors or whatever you want to say about it.

So I think a healthy discussion of a usury ceiling is good for us to better understand what the forces of money and the market really are, and maybe, if we are not going to have—if we are or are not going to have a national usury ceiling, maybe we ought to also establish what some better guidelines might be in some other types of legislation that have an indirect bearing, and also on the private sector in the way the market and money market and other areas handle themselves.

So I think it is a healthy discussion. I appreciate your candor, your opinions so far, and look forward to hearing more.

Thank you, Mr. Chairman.

Chairman FAUNTROY. I thank you, Mr. Hansen.

Let me also again thank you, Mr. Christian, for a very thorough and well-documented presentation. We look forward now to the testimony of Mr. Kalchbrenner.

STATEMENT OF JOHN H. KALCHBRENNER, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, SHAWMUT BANK OF BOSTON, N.A., ON BEHALF OF AMERICAN BANKERS ASSOCIATION

Mr. KALCHBRENNER. Thank you, Mr. Chairman, Mr. Hansen.

Our statement is relatively brief, and I would like to present the entire statement this morning.

I am John H. Kalchbrenner, senior vice president and chief economist of Shawmut Bank of Boston, and a member of the economic advisory committee of the American Bankers Association. Our association's membership includes more than 90 percent of the Nation's full service banks. While our members range in size from

the smallest to the largest banks, approximately 90 percent of them have assets less than $100 million.

We appreciate this opportunity to testify today on the issues of national usury ceilings addressed in H.R. 4471, H.R. 4572, H.R. 6512, and H.R. 4826; and the structure and independence of the Federal Reserve System addressed in H.R. 5066. Mr. Chairman, ABA has consistently opposed both the imposition of usury ceilings and attempts to politicize the Federal Reserve. We believe that the initiatives contained in these bills are counterproductive.

Over the last several years, our economy has experienced unprecedented rates of inflation, high and volatile interest rates, growing unemployment, and significant dislocations in the housing and automobile industries. Recently, both inflation and interest rates have shown some improvement, but unemployment remains too high, and GNP growth remains sluggish.

Legitimate concerns have been raised about the level of interest rates vis-a-vis the rate of inflation, and about the effects of today's interest rates on economic recovery. Mr. Chairman, we all want lower interest rates, and an adequate flow of credit to all sectors of the economy. However, we firmly believe that Government interference in the credit markets is not the way to achieve these goals; in fact, we believe the evidence clearly shows that usury ceilings do considerably more harm than good.

Virulent inflation and inflationary expectations over the past several years are responsible for soaring interest rates and the resulting distortions to the traditional distribution of available credit. Government efforts to deal with inflation have in the past been ineffectual because they have been abandoned too soon. This unhappy track record in dealing with inflation has led to considerable public skepticism regarding the ability of the Government to follow through with an anti-inflation program. Until this skepticism is deflated, inflationary expectations remain uncertain keeping interest rates stubbornly high vis-a-vis measured inflation.

The key to reducing interest rates is to reduce the expected level of inflation. We believe this can only be accomplished by adherence to responsible fiscal and monetary policy. The process of winding down the deeply entrenched forces of inflation is proving to be difficult and painful, but slowly we are making progress.

In the midst of the difficulties of bringing inflation under control, a Government mandated reduction in interest rates may seem to offer a painless way to hasten the return to economic well-being. But usury ceilings cannot restore economic health; attempts to supersede market forces by Government fiat will only complicate an already complex situation. We must not be sidetracked from the pursuit of responsible monetary and fiscal policies which are the only way to achieve lasting economic stability.

Proponents of usury ceilings often mistakenly argue that the issue is simply one of advocating low versus high interest rates. Usury ceilings affect both the availability and the price of credit. These effects are frequently not what the proponents of usury ceilings intend. As the costs incurred by lenders exceed the usury ceiling, the market is constrained from working freely. Faced with restrictive usury ceilings which prevent charging a market rate, creditors have several options.

The most obvious adjustment is to decrease credit availability. In this case, small, inexperienced, and high risk borrowers will be rationed out of the market; on the other hand, prime borrowers may tend to borrow more than they otherwise would because of the lower rate of interest.

Lenders may also respond to binding usury ceilings by increasing credit-related fees. In this case, the explicit rate set by the usury ceiling will lie below the market rate, but the actual rate—including the increased costs—will be higher than the usury ceiling. Adjustments can likewise be made in credit terms; for example, downpayments may be increased, maturities shortened, collateral requirements tightened, minimum loan size requirements might be established, et cetera. Each of these adjustments reduces the cost to the lender; they also make it more difficult for low income, high risk borrowers to obtain credit.

Lenders may also change the conditions and prices of credit-related items. For example, retail creditors can raise the price of their products to make up for below market rate financing. Creditors who purchase credit instruments from retailers can adjust their terms to lower their risk and/or increase their returns. In this instance, the cost of holding usury ceilings below the market rate will be borne by all consumers in the form of higher retail prices.

Clearly, the impact of binding usury ceilings is disadvantageous to the borrowing public. Moreover, the adverse impact of restrictive usury ceilings is greatest on the less sophisticated and less affluent borrowers, as well as first-time credit seekers. Since these borrowers generally have a higher risk premium, they will either be totally shut off from legitimate credit markets when the cost of credit approaches the usury ceiling, or they will be able to obtain credit only under more stringent terms—for example, higher downpayment, shorter maturity, et cetera—which they may be less able to handle than a higher rate of interest.

Mr. Chairman, with respect to the specific issues you asked me to address in the testimony, I believe that this brief discussion clearly indicates that usury ceilings are counterproductive to the efficient functioning of our capital markets. Those industries most heavily dependent on credit will of course be most seriously hurt by binding usury ceilings.

Numerous studies have found that restrictive usury ceilings significantly reduce both the supply of mortgage credit and construction of single-family housing. Moreover, a recent study of usury ceilings in Tennessee indicated that the State's 10-percent usury ceiling significantly slowed the growth of the State's economy during periods of high interest rates, causing a reduction in output, jobs, and retail sales.

Attached to this testimony is a partial bibliography of studies on the effects of usury ceilings; the overwhelming evidence from these studies reinforces our conclusion that binding usury ceilings have an adverse effect on the economy. To the extent that usury laws are aimed at specific areas of the economy, that is consumer lending, mortgage lending, et cetera, those industries dealing in controlled credit will become relatively less important. To the extent that all extensions of credit are controlled, the result will be re-

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duced credit availability. Reduced domestic asset yields will result in reduced savings and increased consumption, and an increase in the flow of funds to unregulated international markets.

The impact of binding usury ceilings will fall unevenly on financial institutions. Institutions which specialize in those types of assets subject to usury laws will obviously be most seriously affected. For example, commercial banks and savings and loan associations are essentially limited by regulation to holding debt instruments, which would be subject to usury ceilings. On the other hand, nondepository financial institutions, such as insurance companies and investment companies, can invest in assets not subject to usury laws, such as equities and real estate.

The result is likely to be a decrease in the market share of those institutions dealing in credit subject to usury ceilings, and an increase in the market share of those institutions holding financial assets not subject to usury ceilings. Moreover, this negative impact on depository institutions will hinder them from paying a market rate of return to their savings customers.

In 1980, Congress formally recognized that restrictions on the rates depository institutions may pay for deposits are counterproductive. The Depository Institution Deregulation and Monetary Control Act of 1980 provided for a phaseout of deposit rate ceilings, leaving the institutions free to compete for funds in the open market. If depository institutions are to pay market rates to obtain deposits, clearly they must not be prevented from charging market rates on loans.

This reality was recognized in the Depository Institution Deregulation and Monetary Control Act of 1980 which included a temporary Federal preemption of State usury laws. We believe that everyone—borrowers, lenders, and savers—will be better served by a capital market free from artificial impediments. We have therefore consistently supported removal of usury ceilings as an essential element in the overall process of financial institution deregulation.

The mushrooming size of the Federal deficit has undoubtedly had an impact on the price of debt. It is imperative that Government spending be brought under control, and that Government demands on capital markets be reduced. We believe that responsible fiscal policy, in conjunction with a stable monetary policy, will result in a lowering of both inflationary expectations and interest rates. We do not believe that the Nation would be well served by simply mandating the interest rate the Government may pay on its debt instruments.

If the mandated rate is set below a market clearing rate, either the Federal Reserve must pursue a monetary policy expansive enough to lower the market rate, or Government debt will go unsold. Prior to 1951, there was an informal agreement between the Federal Reserve and the Treasury to peg the interest on Government debt below a market clearing rate. In order to do this, the Federal Reserve had to pursue an expansive monetary policy; the result was substantial inflation.

One further comment needs to be made with respect to H.R. 5066, the Federal Reserve System Reform Act. This bill proposes a significant reduction in the independence of the Federal Reserve to design and implement monetary policy. There is no question that

constitutional power to control the Federal Reserve lies with Congress. The existence of such ultimate power does not, however, imply that the Federal Reserve's monetary policy should be determined by Members of Congress. The essential advantage of an independent monetary authority is that it can take a longer view of economic trends than the administration or the Congress.

An independent monetary authority, having flexibility in its policy actions, appears to hold the best promise for achieving and maintaining long-term stability in the general level of prices. We fully support the continuation of a constructive congressional dialog with the Federal Reserve to communicate your understandable and justifiable concerns about economic conditions.

This dialog has been formalized by the Humphrey-Hawkins Act; we believe that this process is very constructive. However, we do not believe it is appropriate for Congress itself to specify the design and implementation of monetary policy. An independent Federal Reserve should be recognized as a major element in the system of checks and balances by which our national economic policy is formulated and implemented.

In sum, Mr. Chairman, ABA believes that the economic stability we all seek can be best achieved through consistent pursuit of responsible fiscal and monetary policies. We have supported and will continue to support this approach. We believe that Government-mandated usury ceilings will be counterproductive. Further, we believe that increased politicization of the conduct of monetary policy is not in the public interest.

Thank you.

[The prepared statement of Mr. Kalchbrenner, on behalf of the American Bankers Association, follows:]

STATEMENT

OF

JOHN H. KALCHBRENNER

Mr. Chairman and members of the Subcommittee, I am John H. Kalchbrenner, Senior Vice President and Chief Economist of Shawmut Bank of Boston, and a member of the Economic Advisory Committee of the American Bankers Association. Our Association's membership includes more than 90% of the nation's full service banks. While our members range in size from the smallest to the largest banks, approximately 90% of them have assets less than $100 million.

We appreciate this opportunity to testify today on the issues of national usury ceilings addressed in H.R. 4471, H.R. 4572, H.R. 6512, and H.R. 4826; and the structure and independence of the Federal Reserve System addressed in H.R. 5066. Mr. Chairman, ABA has consistently opposed both the imposition of usury ceilings and attempts to politicize the Federal Reserve. We believe that the initiatives contained in these bills are counterproductive.

Over the last several years, our economy has experienced unprecedented rates of inflation, high and volatile interest rates, growing unemployment,and significant dislocations in the housing and automobile industries. Recently, both inflation and interest rates have shown some improvement, but unemployment remains too high, and GNP growth remains sluggish. Legitimate concerns have been raised about the level of interest rates vis-a-vis the rate of inflation, and about the effects of today's interest rates on economic recovery. Mr. Chairman, we all want lower interest rates, and an adequate flow of credit to all sectors of the economy. However, we firmly believe that government interference in the credit markets is not the way to achieve these goals; in fact, we believe the evidence clearly shows that usury ceilings do considerably more harm than good.

Virulent inflation and inflationary expectations over the past several years are responsible for soaring interest rates and the resulting distortions to the traditional distribution of available credit. Government efforts to deal with inflation have in the past been ineffectual because they have been abandoned too soon. This unhappy track record in dealing with inflation has led to considerable public skepticism regarding the abililty of the government to follow through with an anti-inflation program. Until this skepicism is deflated, inflationary expectations remain uncertain keeping interest rates stubbornly high vis-a-vis measured inflation. The key to reducing interest rates is to reduce the expected level of inflation. We believe this can only be accomplished by adherence to responsible fiscal and monetary policy. The process of winding down the deeply entrenched forces of inflation is proving to be difficult and painful, but slowly we are making progress.

In the midst of the difficulties of bringing inflation under control, a government mandated reduction in interest rates may seem to offer a painless way to hasten the return to economic well-being. But usury ceilings cannot restore economic health; attempts to supersede market forces by government fiat will only complicate an already complex situation. We must not be sidetracked from the pursuit of responsible monetary and fiscal policies which are the only way to achieve lasting economic stability.

Proponents of usury ceilings often mistakenly argue that the issue is simply one of advocating low versus high interest rates. Usury ceilings affect both the availability and the price of credit. These effects are frequently not what the proponents of usury ceilings intend. As the costs incurred by lenders exceed the usury ceiling, the market is constrained from working freely. Faced with restrictive usury ceilings which prevent

charging a market rate, creditors have several options. The most obvious adjustment is to decrease credit availability. In this case, small, inexperienced and high risk borrowers will be rationed out of the market; on the other hand, prime borrowers may tend to borrow more than they otherwise would because of the lower rate of interest.

Lenders may also respond to binding usury ceilings by increasing credit related fees. In this case, the explicit rate set by the usury ceiling will lie below the market rate, but the actual rate — including the increased costs — will be higher than the usury ceiling. Adjustments can likewise be made in credit terms; for example, downpayments may be increased, maturities shortened, collateral requirements tightened, minimum loan size requirements might be established, etc. Each of these adjustments reduces the cost to the lender; they also make it more difficult for low income, high risk borrowers to obtain credit.

Lenders may also change the conditions and prices of credit-related items. For example, retail creditors can raise the price of their products to make up for below market rate financing. Creditors who purchase credit instruments from retailers can adjust their terms to lower their risk and/or increase their returns. In this instance, the cost of holding usury ceilings below the market rate will be borne by all consumers in the form of higher retail prices.

Clearly, the impact of binding usury ceilings is disadvantageous to the borrowing public. Moreover, the adverse impact of restrictive usury ceilings is greatest on the less sophisticated and less affluent borrowers, as well as first time credit seekers. Since these borrowers generally have a higher risk premium, they will either be totally shut off from legitimate credit markets when the cost of credit approaches the usury ceiling, or they

will be able to obtain credit only under more stringent terms (e.g. higher dowpayment, shorter maturity, etc.) which they may be less able to handle than a higher rate of interest.

Mr. Chairman, with respect to the specific issues you asked me to address in this testimony, I believe that this brief discussion clearly indicates that usury ceilings are counterproductive to the efficient functioning of our capital markets. Those industries most heavily dependent on credit will of course be most seriously hurt by binding usury ceilings. Numerous studies have found that restrictive usury ceilings significantly reduce both the supply of mortgage credit and construction of single family housing. Moreover, a recent study of usury ceilings in Tennessee[1] indicated that the state's 10% usury ceiling[2] significantly slowed the growth of the state's economy during periods of high interest rates, causing a reduction in output, jobs, and retail sales. Attached to this testimony is a partial bibliography of studies on the effects of usury ceilings; the overwhelming evidence from these studies reinforces our conclusion that binding usury ceilings have an adverse effect on the economy. To the extent that usury laws are aimed at specific areas of the economy, i.e. consumer lending, mortgage lending, etc., those industries dealing in controlled credit will become relatively less important. To the extent that all extensions of credit are controlled, the result will be reduced credit availability. Reduced domestic asset yields will result in reduced savings and increased consumption, and an increase in the flow of funds to unregulated international markets.

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[1] Harold Nathan, "Economic Analysis of Usury Laws," Journal of Bank Research, Winter 1980.

[2] The 10% usury ceiling is no longer in effect in Tennessee.

The impact of binding usury ceilings will fall unevenly on financial institutions. Institutions which specialize in those types of assets subject to usury laws will obviously be most seriously affected. For example, commercial banks and savings and loan associations are essentially limited by regulation to holding debt instruments, which would be subject to usury ceilings. On the other hand, non-depository financial institutions, such as insurance companies and investment companies, can invest in assets not subject to usury laws, such as equities and real estate. The result is likely to be a decrease in the market share of those institutions dealing in credit subject to usury ceilings, and an increase in the market share of those institutions holding financial assets not subject to usury ceilings. Moreover, this negative impact on depository institutions will hinder them from paying a market rate of return to their savings customers.

In 1980, Congress formally recognized that restrictions on the rates depository institutions may pay for deposits are counterproductive. The Depository Institution Deregulation and Monetary Control Act of 1980 provided for a phase out of deposit rate ceilings, leaving the institutions free to compete for funds in the open market. If depository institutions are to pay market rates to obtain deposits, clearly they must not be prevented from charging market rates on loans. This reality was recognized in the Depository Institution Deregulation and Monetary Control Act of 1980 which included a temporary federal preemption of state usury laws. We believe that everyone — borrowers, lenders, and savers — will be better served by a capital market free from artificial impediments. We have therefore consistently supported removal of usury ceilings as an essential element in the overall process of financial institution deregulation.

The mushrooming size of the federal deficit has undoubtedly had an impact on the price of debt. It is imperative that government spending be brought under control, and that government demands on capital markets be reduced. We believe that responsible fiscal policy, in conjunction with a stable monetary policy, will result in a lowering of both inflationary expectations and interest rates. We do not believe that the nation would be well served by simply mandating the interest rate the government may pay on its debt instruments. If the mandated rate is set below a market clearing rate, either the Federal Reserve must pursue a monetary policy expansive enough to lower the market rate, or government debt will go unsold. Prior to 1951, there was an informal agreement between the Federal Reserve and the Treasury to peg the interest on government debt below a market clearing rate. In order to do this, the Federal Reserve had to pursue an expansive monetary policy; the result was substantial inflation.

One further comment needs to be made with respect to H.R. 5066, The Federal Reserve System Reform Act. This bill proposes a significant reduction in the independence of the Federal Reserve to design and implement monetary policy. There is no question that constitutional power to control the Federal Reserve lies with Congress. The existence of such ultimate power does not, however, imply that the Federal Reserve's monetary policy should be determined by Members of Congress. The essential advantage of an independent monetary authority is that it can take a longer view of economic trends than the Administration or the Congress. An independent monetary authority, having flexibility in its policy actions, appears to hold the best promise for achieving and maintaining long-term stability in the general level of prices. We fully support the continuation of a constructive Congressional dialogue with the Federal Reserve to communicate

your understandable and justifiable concerns about economic conditions. This dialogue has been formalized by the Humphrey-Hawkins Act; we believe that this process is very constructive. However, we do not believe it is appropriate for Congress itself to specify the design and implementation of monetary policy. An independent Federal Reserve should be recognized as a major element in the system of checks and balances by which our national economic policy is formulated and implemented.

In sum, Mr. Chairman, ABA believes that the economic stability we all seek can be best achieved through consistent pursuit of responsible fiscal and monetary policies. We have supported and will continue to support this approach. We believe that government mandated usury ceilings will be counterproductive. Further, we believe that increased politicization of the conduct of monetary policy is not in the public interest.

ATTACHMENT A

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Chairman FAUNTROY. I thank you, Mr. Kalchbrenner. It is very clear from each of your testimonies where you stand on this issue.

Much of the discussion is centered around a fixed percentage usury ceiling. I wonder if any of you would comment on whether or not an indexed interest ceiling might meet some of the concerns you have raised. I am thinking for example of an indexed ceiling that would move at some real rate level above inflation.

Mr. CHRISTIAN. Mr. Chairman, I did note in my testimony that if for whatever reason you feel that it is absolutely essential to have some kind of usury law, that it should be flexible. That is, it should respond to market conditions and not be an absolute limit. I am inclined to believe, however, that that is clearly a second-best kind of choice. There are other laws on the books for consumer protection and the like. I am just not really sure that this kind of a law is needed. However, if it is felt to be essential, then clearly, one that is indexed to market forces makes much better sense than absolute limits, which make no sense at all.

Chairman FAUNTROY. Mr. Larkin.

Mr. LARKIN. I think on page 23 of our prepared report we make this comment:

> An indexed interest rate, especially a rate indexed through an artificially imposed Treasury bill rate, while slightly more flexible than a flat rate, still represents an arbitrary restraint on the free market system.

In our experience, there is no index that accurately reflects the multitude of factors that must be included in pricing credit services. Indices tied to some indication of money costs ignore operating and other nonmoney expenses. Moreover, there is no index that will consistently provide a valid reflection of even the cost of funds.

Given a competitive market, rates will reach their own level, and an artificial index impedes this mechanism. Let me give you a very solid example from our own experience.

In 1958 we started out in the credit card business charging what turned out to be an annual percentage rate of 18 percent, 1.5 percent per month. Twenty-two years later we were still charging 18 percent. We had changed the way we calculated the 18 percent. We have also added an annual fee. But the basic rate remained unchanged.

I also suggest that certain kinds of credit are complex and are sophisticated, whereas others are simple. You come in and get a simple signature loan, you sign a piece of paper and walk out, that is a very simple procedure. But a credit card loan is like buying processed spinach, where you go to the store and you buy the spinach and it has got all the condiments in it. It is all chopped up. And you drop it in boiling water. And when the water boils you have got your spinach all prepared.

Or your wife goes to the store, buys raw spinach, washes the sand off, chops it up, boils it, puts in condiments. Now, you wouldn't presuppose that the price of raw spinach in one case would be the same as processed spinach in the other. This is all I am trying to say, is that there are so many varieties in the acquisition costs and operating expenses, and even nonoperating expenses involved with loans that the indexing of rates for different loans is so tremendous as to defy description.

We have a time lending guide that embraces some 60 pages and embraces some 300 or 400 different kinds of loan pricing for different kinds of just consumer credit loans, depending upon the downpayment, depending upon the size of the loan, depending upon the maturity, depending upon the type of security. And I would defy you to properly index such a kind of loan situation.

Chairman FAUNTROY. Mr. Kalchbrenner.

Mr. KALCHBRENNER. I would concur with the other members of the panel and just make one quick observation. If we were attempting to avoid the distortions that all three of us have talked about in our testimony, it would be necessary to set the indexed rate appreciably above the rate of inflation. If that were the case, then it would be better not to have it at all.

Chairman FAUNTROY. To what extent have our tax laws encouraged people to borrow, and to perhaps do so in greater amounts than they might otherwise? In conjunction with that question, let me also ask you whether the fact that interest is deductible has made borrowers less sensitive to the nominal rate, thus making the nominal rate more likely to rise than remain stable?

Mr. Larkin.

Mr. LARKIN. Just to start off, let's assume you have an inflation rate of 8 percent. And you are in a situation where the Government is going to pay 50 percent of the expense, the interest expense. They are going to absorb it. A person can pretty well live with a 16-percent interest rate, because inflation is going to take care of half of it, and what he throws off to the Government takes care of the other half of it.

Actually, our taxing system is inverse. It favors the borrower and penalizes the saver. Yet, what we need is capital formation through savings. If I am in a 50-percent bracket and I have a $100,000 account, half of what I pay in interest goes to Uncle Sam. On the other hand, if I borrow a $100,000, Uncle Sam pays half the cost of the borrowing. So you really have a situation that the Internal Revenue System has to direct itself toward to switch things over to give more incentives to the saver to save and perhaps a few less for the borrower to borrow.

Chairman FAUNTROY. Mr. Christian.

Mr. CHRISTIAN. I would agree with that, Mr. Chairman. I think there is perhaps a deeper thought that we might pursue here. Every instance of taxation or exemption from taxation on one side or another is an effort to promote a certain type of activity. This is in itself a kind of intervention in the market. I am very intrigued by the flat tax notions that simply withdraw both of these kinds of penalties and rewards from the tax system and simply say to the public, look, the Government needs so many dollars to operate. This is your Government. You have got to pay for a piece of it. And it is flat, across the board. That is an extremely appealing concept. In our complex environment I think the more we move toward simplicity in the law, the better off we are going to be.

Chairman FAUNTROY. Thank you.

Mr. Hansen.

Mr. HANSEN. Last Friday an amendment was passed, and I am wondering if any of you would care to comment on the Senate's action.

Mr. CHRISTIAN. I think speaking for the United States League of Saving Associations, we certainly favor that option. Our testimony in opposition to usury laws is consistent with extension of the preemption.

Mr. KALCHBRENNER. We would be able to support that as well, sir.

Mr. HANSEN. Mr. Chairman, I was next door at the subcommittee meeting on proposed gold coinage. Chairman Annunzio was there. I happened to express where I had been a few moments before. I thought it was rather interesting. He had a lot of comments to say which were needless to say 180 degrees from what the gentlemen have just expressed here. So I am sure we will be hearing more about that.

I did want to pursue one thing if I might, Mr. Chairman. That is the flat rate tax that you mentioned, Mr. Christian. Having been one of those strong proponents of flat rate tax for some time, it seems to me that, and I am just wondering if there is agreement and I don't want to belabor it because it may not be totally relevant to our discussion, but I think it does have bearing, because we are talking about interest rates and how to get them down, incentive to keeping interest rates up and this type of thing.

With the flat rate tax it seems if we could draw people out of the underground, the $95 billion that the President states is being lost there in revenue to Uncle Sam, and if we can draw people out of the tax shelters and get the perception of the people in this country feeling that the tax system is basically fair, that everyone is paying a fair share, the same percentage, and studies I have seen illustrate there is possibility of drawing as much as a $100 to $200 billion additional money into the system, into Uncle Sam's pockets, I should say, with even tax relief for those who are currently paying, it seems that this might have enough downward pressure in terms of balancing a budget, reducing the debt, all of these things, that it would make a national usury law somewhat passe.

Is there any thoughts you might have in this regard in a brief way?

Mr. CHRISTIAN. One hates to be too confident about how things that you haven't tried before are going to work out in the future. The compelling notion in my view of a flat tax type of tax system is its simplicity. It is basic and fundamental equity. How it turns out to be drafted and how you fashion the transition from the current tax system, upon which economic decisions have been made, are very important. If you do it suddenly, and without a transition phase, there are going to be economic consequences for individuals and businesses alike. You have to provide very carefully for the transition phase in moving from the current system to a flat tax.

Mr. HANSEN. But, idealistically, you see merit to the system?

Mr. CHRISTIAN. I certainly do.

Mr. HANSEN. Any comments from you, Mr. Kalchbrenner?

Mr. KALCHBRENNER. No, we would agree with that approach—that it does have many attractive aspects to it. I also agree that the transition period would be critical if such a proposal were adopted, care would be needed to avoid the kinds of transition problems we have just been through in the last year in our anti-inflationary efforts in which institutions and individuals had high fixed cost,

long-term obligations that were very difficult to renegotiate in a short period of time.

Mr. HANSEN. Of course parallel systems are not unknown to the IRS.

Mr. KALCHBRENNER. Certainly.

Mr. HANSEN. You have the individuality of filing jointly. That probably could be affected.

Mr. LARKIN. I agree very strongly.

Mr. HANSEN. Thank you, Mr. Chairman.

Chairman FAUNTROY. Mr. Larkin, in answer to a question you noted that if usury ceilings were in effect, funds for housing and other purposes would be diverted elsewhere. Let me pose two scenarios for you. Would lending cease for these purposes if there were no other alternatives which allowed a lender to receive a greater return?

Mr. LARKIN. I don't quite understand the question. I can only answer by saying that in my opinion, rather, general interest rates, are now coming down to the point where the building industry feels that the public is ready to accept those rates and negotiate home construction. What we have had in the last couple of years is not so much the construction of new homes, but a whirling around of existing homes, you know, in so-called creative financing. Creative financing is now coming home to roost. Foreclosures are going to escalate tremendously.

We feel that if there can be this continued downward thrust on the pure interest rate, which affects the real estate rate, and I will say that there have been several times when the real estate rate at my bank was less than the prime rate, you know, for a good and simple reason. We just couldn't charge 21 percent for a home loan. It was absurd. Eighteen percent is absurd. I think 16 percent is absurd. When you get down to around, I think, 12 percent, and you are beginning to see that in some of the newspapers now, as at least attractions to come in and dicker, you are beginning then, I think, to see a change for the better in the housing industry.

The housing industry is so darn important; it affects the railroads, the transportation of all household goods. It affects carpet manufacturers. It affects appliance manufacturers. We have never realized how importantly our economy is tied to just two things, cars and housing, both of which have been very distressed. We have noticed, for example, in the car industry—and this is rather interesting—that the car manufacturer, the captive finance company such as General Motors Acceptance Corp., the dealer, the manufacturer, the finance company have all combined to say, it is important to sell a car. Therefore, it is important that we lower that rate down to a point where the borrower will consider it a relatively good buy.

So even though we as an individual bank might have to charge 15 or 16 percent, we are very happy to see GMAC, a Chevy dealer and, let's say, the manufacturer of General Motors cars get together and offer this lower than market price. It is in a sense a loss leader. But it is done in the sense that, heck, if we can make $400 on the sale of the car, we can afford to give $100 off, you know, on the interest rate. And I think this is the way that people are beginning to think to restore production in the auto industry. And I

think something like this can perhaps happen in the housing industry. I see it coming in the next year or so.

Chairman FAUNTROY. Yes, Mr. Kalchbrenner?

Mr. KALCHBRENNER. I think the importance of reduced interest rates as referred to by Mr. Larkin is absolutely critical because we don't have a typical lead sector to bring us out of the recession that we are in currently. It is our belief, again, that the best way to achieve lower interest rates is not through the kinds of proposals that we are considering today, but a continuation of the attempts to reduce Government expenditures and the size of the Government deficit. The latter has been one of the principal factors causing short-term interest rates to back up periodically in recent months even though economic activity has been very weak. It is the tremendous amount of concern in the financial markets attributable to the very large budget deficits that have to be financed in the current period that has caused the most recent pause in the decline in interest rates and resulted in a delay in the kind of actions we would all like to see.

Mr. LARKIN. I heard a little anecdote about President Kennedy when he took office. He had sleepless nights about the size of the Federal budget, which was then perhaps around $200 billion. And we now think of the interest on the Federal debt as being in that range. So you see, the Government takes such a large share of the available quantity of credit that is available for lending purposes that, if the Government controls itself, and let's say gets back into a state of balance, it, per se, opens up credit availability and, therefore, hopefully a lowering of prices to the private part of the economy. It is a two-way street.

Chairman FAUNTROY. Mr. Larkin, after your spinach analogy and the sleepless night reference, I am tempted to get your card to consult with you on speechwriting.

Mr. LARKIN. Thank you, sir.

Chairman FAUNTROY. Thank you. Mr. Christian?

Mr. CHRISTIAN. Mr. Chairman, I forgot the question, but I remember the answer. So if you remember the question, I remember the answer, maybe we have got something going. As I recall your question, really the response to it was that if you can induce people to lend you money, that is, savers, as a financial institution, at a rate that preserves a profitable spread for your institution, then of course you can put money out at lower interest rates. Even today, if you can find a way to have savers give lending institutions an appropriate amount of money for 4 percent or 3 percent, and what you need is a 2- or 3-point spread between what it costs you to take in savings and maintain them and what it costs you to lend, lending institutions are going to be quite happy with that situation. The point is you can't do that. The savers simply won't come in. You will find a repetition of what we saw only a little while back in this economy, of people moving into tangibles, collectibles, real goods; moving away from financial assets and going to real assets, because the yields on financial assets were—simply made no sense. That restricts the whole credit supply.

Chairman FAUNTROY. Thank you so much, gentlemen. I don't want to prolong your very effective testimony for the committee unduly. I do so appreciate your having taken the time to prepare

very thorough and obviously well-documented statements. I will share them with our colleagues and may from time to time over the next few weeks submit direct questions to you on matters which you may not have covered today. Thank you so very much.

Our next panel of witnesses includes Mr. Richard Rahn, vice president/chief economist of the Chamber of Commerce of the United States; Mr. James W. Hacking, assistant legislative counsel with the American Association of Retired Persons; and Thomas A. Durkin, director of research and education at the National Consumer Finance Association.

Gentlemen, we are happy and pleased to welcome you as well to our Domestic Monetary Subcommittee hearings on legislation authorizing a national usury ceiling. As with the previous panel we will, without objection, enter your full prepared statements in the record. You may feel free to present your testimony in whatever fashion makes you comfortable.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT/CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. RAHN. Thank you, Mr. Chairman.

Mr. Chairman, I am Richard W. Rahn, vice president and chief economist for the Chamber of Commerce of the United States. I am accompanied today by our staff economist, Doug Kinney. On behalf of the chamber's more than 250,000 members, I welcome this opportunity to present our opposition to H.R. 4572, the National Usury Act, and to similar proposals which would establish a national interest rate ceiling. In the interest of time I will summarize my statement and request that my entire statement be made a part of the record.

Chairman FAUNTROY. Without objection so ordered.

Mr. RAHN. Although misguided, the temptation to impose a national usury law stems from the recent U.S. experience with high interest rates. However, such measures are inappropriate because prices—in this case interest rates—generated by the interaction of suppliers and demanders in well-organized, competitive markets merely reflect the optimal adjustment of these individuals to perceived economic circumstances—both present and future. Consequently, artificial restrictions on prices are equivalent to killing the messenger who brings bad news. The problem is not eliminated; we simply lose the benefit of the messenger's service.

The behavior of interest rates over the past 3 years can be explained in terms of the rational response of lenders and borrowers to adverse economic conditions, especially price inflation, and to the Federal Reserve Board's highly erratic performance in trying to limit monetary growth in order to reduce inflation. Nominal interest rates actually began rising in 1977 as lenders demanded, and borrowers willingly paid, higher rates of interest in order to compensate the former for the anticipated loss of purchasing power on their loan principal due to anticipated inflation. By 1979, inflation, as measured by the Consumer Price Index, was running in excess of 12 percent per year. This circumstance prompted the Federal Reserve Board in October of that year to announce that it would

henceforth stabilize and reduce the rate of growth of the money supply in order to fight inflation.

Since persistent inflation results from excessive monetary growth, the policy adopted by the Fed in the fall of 1979 was entirely appropriate. Had the Fed subsequently performed as it promised to, interest rates would have come down along with the rate of price increase. Instead of stabilizing monetary growth, however, Federal Reserve officials allowed it to become even more variable. In addition, M_1 was repeatedly permitted to grow over short periods at rates in excess of annual target levels.

The highly erratic behavior of M_1 throughout 1980 and early 1981 created a great deal of uncertainty among investors about the Fed's commitment to its own policy and caused lenders to maintain high nominal interest rates for fear of renewed inflation. Yet, despite the shortrun deviations from its stated policy, the Fed did succeed in reducing the rate of monetary growth over longer time periods, and, as a result, inflation has been reduced to approximately 5 to 6 percent per year.

Interest rates, both long and short term, have also been declining for over 1 year now along with inflation. This decline has been particularly dramatic in the past 2½ months. In August 1981, the prime rate averaged 20.50 percent; the annual rate on 3-month Treasury bills was 15.51 percent. In August of this year, the prime rate averaged 14.39 percent, while the 3-month T-bill yield was 8.68 percent. These are reductions of more than 6 percentage points over the past year. With the exception of rates on conventional mortgages, long-term interest rates have been declining as well. In short, market forces appear to be bringing interest rates down automatically to levels warranted by economic conditions, thus demonstrating once again the folly of interfering with the operation of a competitive market under the pretext of improving its performance. Moreover, a usury limit would not have prevented the excessive monetary growth which led to runaway inflation in 1979 and 1980. Instead, a below-market usury ceiling would have forced lenders to compensate for anticipated inflation in ways other than demanding higher nominal interest rates. The adverse consequences of such behavior should not go unmentioned.

First of all, there is the very likely possibility that both lenders and borrowers would search for ways to circumvent an economically binding usury ceiling. Large corporations wishing, but not able, to obtain funds at the legal interest limit could issue preferred stock with an implicit promise to pay holders a return in excess of the usury ceiling. An obvious lender response to an effective domestic ceiling on interest rates would be to invest funds abroad where market returns are more favorable. With the exception of predominately Islamic nations, the United States appears to be the only non-Communist country in the world which has actually operated under usury laws in modern times. Interest rates in several European countries are currently equal to or greater than those in the United States, so the possibility of massive capital outflows should not be dismissed.

The closing of loopholes and the enforcement of a usury constraint would not only consume resources that could be used more productively elsewhere but would also probably prove to be futile

as well. For example, in extreme situations, additional policing of the nation's borders might be necessary to prevent people from smuggling liquid assets out of the country for the purpose of investing abroad.

Two other manifestations of lender behavior under usury laws are: a reduction in the supply of credit below the amount which would be forthcoming in their absence, and the denial of credit to customers who are judged to be poor credit risks at the maximum allowable interest rate. Evidence of these effects has been documented in numerous studies of the impact of State-imposed usury laws on consumer and mortgage credit. A number of these studies have been cited by previous witnesses. Since an adequate supply of credit is vital to the health of an economy, it follows that artificial restrictions leading to diminished supplies or to misallocation of credit resources would have a deleterious effect on commerce. The only major study examining this question supports this distressing conclusion. The study estimated the macroeconomic costs to the economy of the State of Tennessee during the period from 1974 to 1976 due to its comprehensive 10-percent interest rate limitation. Its findings: The State usury law resulted in an average loss in output of $150 million per year, an average loss of 7,000 jobs per year, retail sales losses of $80 million per year, and losses to financial intermediaries of $1.25 billion per year. Clearly, the economic cost to the national economy of such a law would be staggering.

Virtually all of the available evidence confirms the predictions of economic theory regarding the effects of usury laws. When such restrictions result in artificially low interest rates, they reduce the supply of credit and lead to inefficient, nonprice credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses who are forced to go without credit. Therefore, the U.S. Chamber opposes H.R. 4572 and all similar proposals which would establish a national interest rate ceiling.

Chairman FAUNTROY. I thank you, Mr. Rahn.

[The prepared statement of Mr. Rahn, on behalf of the Chamber of Commerce of the United States, follows:]

STATEMENT
on the
NATIONAL USURY ACT (H.R. 4572)
before the
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
of the
HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Dr. Richard W. Rahn
September 28, 1982

Mr. Chairman, I am Richard W. Rahn, Vice President and Chief Economist for the Chamber of Commerce of the United States. On behalf of the Chamber's more than 250,000 members, I welcome this opportunity to present our opposition to H.R. 4572, the National Usury Act, and to similar proposals which would establish a national interest rate ceiling.

SUMMARY

Like all attempts to interfere with the operation of an efficiently working market, a national usury ceiling would have serious adverse effects on the U.S. economy should it prevent interest rates from rising to market-clearing levels. Evidence suggests the possibility of reductions in the total supply of credit in proportion to the degree of restraint imposed by the ceiling. The reduction in credit availability could take the form of capital outflows to foreign countries in an attempt to avoid the ceiling. As a practical matter, enforcement of such a restriction would be difficult and costly. Empirical evidence also indicates that a below-market usury ceiling would lead to non-price credit rationing by lenders who would discriminate against low and moderate income borrowers and small businesses. Finally, imposition of a legal limit on interest rates runs contrary to the trend toward credit market deregulation embodied in the Depository Institutions Deregulation and Monetary Control Act of 1980.

Our Recent Interest Rate Experience Does Not Demonstrate the Need for a National Usury Law

Although misguided, the temptation to impose a national usury law stems from the recent U.S. experience with high interest rates. However, such measures are inappropriate because prices -- in this case interest rates -- generated by the interaction of suppliers and demanders in well-organized, competitive markets merely reflect the optimal adjustment of these individuals to perceived economic circumstances -- both present and future. Consequently, artificial restrictions on prices are equivalent to killing the messenger who brings bad news. The problem is not eliminated; we simply lose the benefit of the messenger's service.

The behavior of interest rates over the past three years can be explained in terms of the rational response of lenders and borrowers to adverse economic conditions, especially price inflation, and to the Federal Reserve Board's highly erratic performance in trying to limit monetary growth in order to reduce inflation. Nominal interest rates actually began rising in 1977 as lenders demanded, and borrowers willingly paid, higher rates of interest in order to compensate the former for the anticipated loss of purchasing power on their loan principal due to rising prices. By 1979, inflation, as measured by the Consumer Price Index, was running in excess of twelve percent per year. This circumstance prompted the Federal Reserve Board in October of that year to announce that it would henceforth stabilize and reduce the rate of growth of the money supply in order to fight inflation.

Since persistent inflation results from excessive monetary growth, the policy adopted by the Fed in the Fall of 1979 was entirely appropriate. Had the Fed subsequently performed as it promised to, interest rates would have come down along with the rate of price increase. Instead of stabilizing monetary growth, however, Federal Reserve officials allowed it to become even more variable. In addition, M_1 was repeatedly permitted to grow over short periods at rates in excess of annual target levels.

The highly erratic behavior of M_1 throughout 1980 and early 1981

created a great deal of uncertainty among investors about the Fed's commitment to its own policy and caused lenders to maintain high nominal interest rates for fear of renewed inflation. Yet, despite the short-run deviations from its stated policy, the Fed did succeed in reducing the rate of monetary growth over longer time periods, and, as a result, inflation has been reduced to approximately five to six percent per year.

Interest rates, both long- and short-term, have also been declining for over a year now along with inflation. This decline has been particularly dramatic in the past two-and-one-half months. In August 1981, the prime rate averaged 20.50 percent; the annual rate on three-month treasury bills was 15.51 percent. In August of this year, the prime rate averaged 14.39 percent, while the three-month T-bill yield was 8.68 percent. These are reductions of more than six percentage points over the past year. With the exception of rates on conventional mortgages, long-term interest rates have been declining as well.

In short, market forces appear to be bringing interest rates down automatically to levels warranted by economic conditions, thus demonstrating once again the folly of interfering with the operation of a competitive market under the pretext of improving its performance. Moreover, a usury limit would not have prevented the excessive monetary growth which led to runaway inflation in 1979 and 1980. Instead, a below-market usury ceiling would have forced lenders to compensate for anticipated inflation in ways other than demanding higher nominal interest rates. The adverse consequences of such behavior should not go unmentioned.

Circumvention and Enforcement Costs

First of all, there is the very likely possibility that both lenders and borrowers would search for ways to circumvent an economically binding usury ceiling. Large corporations wishing, but not able, to obtain funds at the legal interest limit could issue preferred stock with an implicit promise to pay holders a return in excess of the usury ceiling.

An obvious lender response to an effective domestic ceiling on interest rates would be to invest funds abroad where market returns are more favorable. (With the exception of predominately Islamic nations, the United States appears to be the only non-communist country in the world which has actually operated under usury laws in modern times.) Interest rates in several European countries are currently equal to or greater than those in the U.S., so the possibility of massive capital outflows should not be dismissed.

The closing of loopholes and the enforcement of a usury constraint would not only consume resources that could be used more productively elsewhere but would also probably prove to be futile as well. For example, in extreme situations, additional policing of the nation's borders might be necessary to prevent people from smuggling liquid assets out of the country for the purpose of investing abroad.

Usury Laws and Consumers

Two other manifestations of lender behavior under usury laws are: a reduction in the supply of credit below the amount which would be forthcoming in their absence, and the denial of credit to customers who are judged to be poor credit risks at the maximum allowable interest rate. Evidence of these effects have been documented in numerous studies of the impact of state-imposed usury laws on consumer and mortgage credit.* It has been found, for example, that the presence of usury ceilings on conventional

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*For a comprehensive survey of the economic effects of state usury laws, see Harold C. Nathan, "Economic Analysis of Usury Laws," Journal of Bank Research (Winter 1980).

mortgages within a state has dire consequences for the availability of mortgage credit and for housing starts within that state. For each percentage point below the estimated market-clearing rate, mortgage interest ceilings appear to reduce housing starts by sixteen to twenty-eight percent below their "free-market" levels.

Not only do usury laws pertaining to consumer and mortgage interest charges reduce these supplies of credit, but eight independent investigations of their rationing effects indicate that customers who are deemed to be poor credit risks are simply denied credit by lenders. Of course, these poor credit risks tend to be low or moderate income individuals, or even young adults who have yet to establish credit records. These persons have no recourse but to go without credit or else obtain it from illegal sources. This sort of non-price rationing could be prevalent among commercial lenders as well, with the obvious adverse consequences for small businesses which rely very heavily on external funds.

The Macroeconomic Effects of Usury Laws

Since an adequate supply of credit is vital to the health of an economy, it follows that artificial restrictions leading to diminished supplies or to misallocation of credit resources would have a deleterious effect on commerce. The only major study examining this question supports this distressing conclusion. The study estimated the macroeconomic costs to the economy of the state of Tennessee during the period from 1974 to 1976 due to its comprehensive 10 percent interest rate limitation.** Its findings:

**See Richard Gustely and Harry L. Johnson, Impact of the Tennessee Constitutional Usury Limit on the Tennessee Economy, Center for Business and Economic Research, College of Business Administration, The University of Tennessee, Knoxville, Tennessee (June 1977).

The state usury law resulted in an average loss in output of $150 million per year, an average loss of 7,000 jobs per year, retail sales losses of $80 million per year, and losses to financial intermediaries of $1.25 billion per year. Clearly, the economic cost to the national economy of such a law would be staggering.

CONCLUSION

Virtually all of the available evidence confirms the predictions of economic theory regarding the effects of usury laws. When such restrictions result in artifically low interest rates, they reduce the supply of credit and lead to inefficient, non-price credit rationing. These distortions impose enormous costs on the economy and discriminate against low-income borrowers and small businesses who are forced to go without credit. Therefore, the U.S. Chamber opposes H.R. 4572 and all similar proposals which would establish a national interest rate ceiling.

Chairman FAUNTROY. In the absence of Mr. Hacking we have Mr. Robert Brunner, representing the Association for Retired Persons. Mr. Brunner, we welcome you. We have Mr. Hacking's statement in its entirety. You may proceed to testify in whatever manner you choose.

STATEMENT OF ROBERT O. BRUNNER, LEGISLATIVE REPRESENTATIVE, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. BRUNNER. Our statement is not very long, so I will read it with a little abbreviation.

Our association represents 13.5 million persons over age 55. We welcome the opportunity to testify on the several bills that have been introduced proposing some type of interest rate ceiling.

While we understand the frustrations over high interest rates that furnish the motivation for the introduction of these bills, we feel compelled to oppose them, for several reasons. The first is that they are, to put it politely, quixotic; they would not produce the results their proponents envisage, unless perhaps they were accompanied by ceilings on interest rates paid to savers. If that were done, the proposals would be even more objectionable, because they would continue the subsidy of borrowers by lenders and savers, one of the ways in which the United States has discouraged saving over the past 15 years—with all the adverse economic consequences that has entailed. On balance, the elderly tend to be creditors, not debtors, so that limiting what can be earned on savings would worsen their income position. In 1977, taxpayers 65 and older derived about one-quarter of their income from interest.

The fact that the elderly are net creditors does not mean, however, that AARP favors the highest possible level of interest rates. We are well aware of the adverse effects on the economy of the high and fluctuating interest rates of the last 2 years, and the resulting reduction in social security payroll tax and other revenues.

We know the pressures to cut entitlement program benefits that these revenue shortfalls generate. These are of vital importance to the elderly. A high level of interest rates, per se, is not our goal, although it should be noted that a high level should tend to increase savings, other things being equal.

Our point is that savers, including the elderly, should not be compelled to accept returns on their savings below what the market is willing to pay. In particular, holders of passbook accounts, in which group the elderly are disproportionately represented, should not continue to be subject to discriminatory ceilings on their interest earnings, in the form of regulation Q. We stress this because the unspoken corollary of setting rates to homeowners below market levels would seem to be setting rates for lenders, that is on savings, below market levels. Indeed, this would have to be done if the limits on rates for some kinds of borrowings, for example, mortgage loans, were to be effective. Mortgage lenders would simply have to stop lending if the cost of their funds could not be kept below the ceiling rates for their loans.

With respect to other types of lending in which it is not possible to easily identify, and impose limits on, the suppliers of the loan funds, the result of limitations on loan rates would be that the institutions or individual investors would simply stop making the loans, or buying the bonds, or whatever financial instrument is used. This has been the effect in some States which had below-market usury loan ceilings; some kinds of loans simply became unavailable. Lendable funds are like water, except that they seek the highest level, not the lowest. If a barrier in the form of an interest rate ceiling is established, funds will move elsewhere. We think it makes little sense to deprive potential borrowers of the ability to borrow, in the name of protecting them from high interest rates. There is no way to direct funds to below-market investments without comprehensive credit controls, which could almost certainly not be made to work, because they would not command popular support. Perhaps comprehensive credit controls are what proponents of this legislation really want; if so, it would help if they would say so.

H.R. 5066, the Federal Reserve System Reform Act, introduces additional complications. The Federal Reserve, as we understand the bill, is supposed to establish annually not only target rates of growth for the money supply, which is already done more frequently, but also set interest rates, including the Federal Reserve discount, or rediscount, rate. However, the discount rate follows changes in market interest rates, it does not determine them, so it has to be free to be adjusted for changes in money and credit conditions.

The concluding comment on all these bills is that they seek to suppress the symptoms of a sickness without attacking the sickness itself. The sickness can be described as the fear of inflation resulting from the huge budget deficits of the years ahead. It is not much of an oversimplification to say that Congress voted for high interest rates when it voted the 1981 tax cut package, deceptively advertised as an "Economic Recovery" tax package. Progress in simultaneously reducing the admittedly still high level of interest rates, while simultaneously restoring growth in the economy, will depend

in large part on correcting the mistakes of the 1981 tax cut. A beginning has been made with the recent tax bill, despite its flaws, but there is still a long way to go.

Chairman FAUNTROY. I thank you, Mr. Brunner.

[The prepared statement of Mr. Brunner, on behalf of the American Association of Retired Persons, follows:]

STATEMENT

OF THE

AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons, representing 13.5 million persons over age 55, welcomes the opportunity to testify on the several bills that have been introduced proposing some type of interest rate ceiling. The bills that we are aware of are the following:

1) H.R. 4471 and 4572 which limit interest rates to 10% on loans of more than $300;

2) H.R. 4826 and 6512 which limit interest rates on U. S. Government obligations and establish an indexed rate ceiling; and

3) H.R. 5066 which provides for the annual setting of interest rates and monetary growth targets by the Federal Reserve System.

While we understand the frustrations over high interest rates that furnish the motivation for the introduction of these bills, we feel compelled to oppose them, for several reasons. The first is that they are, to put it politely, quixotic; they would not produce the results their proponents envisage, unless perhaps they were accompanied by ceilings on interest rates paid to savers. If that were done, the proposals would be even more objectionable, because they would continue the subsidy of borrowers by lenders and savers, one of the ways

in which the U.S. has discouraged saving over the past 15 years -- with all the adverse economic consequences that has entailed. On balance, the elderly tend to be creditors, not debtors, so that limiting what can be earned on savings would worsen their income position. In 1977, taxpayers 65 and older derived about one quarter of their income from interest.

The fact that the elderly are net creditors does not mean, however, that AARP favors the highest possible level of interest rates. We are well aware of the adverse effects on the economy of the high and fluctuating interest rates of the last two years, and the resulting reduction in social security payroll tax and other revenues. We know the pressures to cut entitlement program benefits that these revenue shortfalls generate. A high level of interest rates, per se, is not our goal, although it should be noted that a high level should tend to increase savings, other things being equal.

Our point is that savers, including the elderly, should not be compelled to accept returns on their savings below what the market is willing to pay. In particular, holders of passbook accounts, in which group the elderly are disproportionately represented, should not continue to be subject to discriminatory ceilings on their interest earnings, in the form of Regulation Q. We stress this because the unspoken corollary of setting rates to homeowners below market levels would seem to be setting rates for lenders, i.e., on savings,

below market levels. Indeed, this would have to be done if the limits on rates for some kinds of borrowings, for example, mortgage loans, were to be effective. Mortgage lenders would simply have to stop lending if the cost of their funds could not be kept below the ceiling rates for their loans.

With respect to other types of lending in which it is not possible to easily identify, and impose limits on, the suppliers of the loan funds, the result of limitations on loan rates would be that the institutions or individual investors would simply stop making the loans, or buying the bonds, or whatever financial instrument is used. This has been the effect in some states which had below-market "usury" loan ceilings; some kinds of loans simply became unavailable. Lendable funds are like water, except that they seek the highest level, not the lowest. If a barrier in the form of an interest rate ceiling is established, funds will move elsewhere. We think it makes little sense to deprive potential borrowers of the ability to borrow, in the name of protecting them from high interest rates. There is no way to direct funds to below-market investments without comprehensive credit controls, which could almost certainly not be made to work, because they would not command popular support. Perhaps comprehensive credit controls are what proponents of this legislation really want; if so, they should say so.

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The concluding comment on all these bills is that they seek to suppress the symptoms of a sickness without attacking the sickness itself. It is not much of an oversimplification to say that Congress voted for high interest rates when it voted the 1981 tax cut package, deceptively advertised as an "Economic Recovery" tax package. Progress in simultaneously reducing the admittedly still high level of interest rates, while simultaneously restoring growth in the economy, will depend in large part on correcting the mistakes of the 1981 tax cut. A beginning has been made with the recent tax bill, despite its flaws, but there is still a long way to go.

Chairman FAUNTROY. We will now move to Mr. Durkin. We have your testimony as well in its entirety. We will enter it into the record and you may proceed in whatever manner you choose.

STATEMENT OF THOMAS A. DURKIN, DIRECTOR OF RESEARCH AND EDUCATION, NATIONAL CONSUMER FINANCE ASSOCIATION

Mr. DURKIN. Thank you, Mr. Chairman.

My name is Thomas A. Durkin. I am director of research and education of the National Consumer Finance Association [NCFA] and adjunct senior research associate in finance at the Pennsylvania State University. I welcome the opportunity to comment today on NCFA's views concerning bills before this subcommittee that would set a national usury ceiling.

NCFA shares the concerns of the sponsors of these bills that market interest rates are too high. However, because these bills do nothing to repair the Government policies that have produced high domestic interest rates, we question their usefulness. Furthermore, because these bills are likely to exacerbate our current economic difficulties by creating credit shortages, by disadvantaging the consumer sector of the economy, and by creating in one more area of the economy massive bureaucratic enforcement procedures, we must vigorously oppose their passage.

Interest is, of course, the price that those who need additional current resources are willing to pay to have them made available. Interest is paid to those with saved resources they are willing to lend—usually, in our economy, through financial institutions. Thus, financial institutions are conduits or intermediaries that channel resources from savers to borrowers, returning the interest borrowers are willing to pay and which savers require.

In an economy like ours with financial markets and institutions, the price of credit is determined like the price of anything else—by supply and demand in free markets. For any given supply of resources by savers, interest rates will rise if the demand for borrowing rises. Likewise, interest rates will fall if the demand for borrowing falls. Very simply, then, the interest rate at any time is the price of credit that just balances supply and demand. Any deviation of supply or demand from this balance will cause interest rates to move up or down.

In our complex economy with many potential users and borrowers of current resources, there is constant, active competition for funds. And, savers and intermediaries with resources to lend have become pretty sophisticated. They are not willing to lend to all on the same terms. Instead, they demand different compensation depending on risk, maturity, and costs involved in credit checking, bookkeeping, and operations. Furthermore, and most importantly, they also demand compensation for expected inflation. If prices of goods and services in the economy are expected to rise 10 percent in a year, suppliers of current resources are hardly likely to supply them for a 3-percent rate of interest. Rather, they will require an inflation premium on top of their usual interest needs. If, for example, their requirement for lending in a noninflationary economy is 3 percent, then if prices are expected to rise by 10 percent a year, resource providers will logically require 13-percent annual compen-

sation. This is apart from the need to cover operating costs and the cost of risk.

Now, what has caused the recent high interest rates in the American economy? The answer is twofold—both, unfortunately, dependent on aspects of Federal policies that have developed over many years. First of all, the Federal Government's demand for funds has been almost insatiable in recent years. The desire to increase spending faster than revenues year in and year out has caused tremendous Federal demands on credit markets. While large deficits obviously could be financed without rising rates if savings expanded sufficiently rapidly, the mammoth size of recent and projected deficits has made this difficult indeed. Second, Federal Government policies have led to inflation. Government's spending more than income while financing part of the difference by printing new money has produced domestic inflation. High and long rising inflation has created inflationary expectations. In this environment savers simply want higher interest rates before they are willing to lend resources.

In short, to use an analogy commonly employed these days, interest rates have become a thermometer measuring an aspect of the economy's health. High interest rates indicate the economy has a disease—massive Federal deficits and continuing inflationary expectations. The question is whether we will seek a cure instead of merely attempting to suppress the symptoms. Or, worse yet, whether we will merely do violence to the thermometer while adding new economic ailments.

Now, having outlined briefly the causes of high and fluctuating interest rates, the next question is what would be the impact of a national usury law? Interest rate ceilings, of course, are not a new idea and so history can be a guide. Rate ceilings were tried as long ago as in the 24th century B.C. Laws of Manu in India. There also were ceilings in the Babylonian Code of Hammurabi and in the ancient laws of Greece and Rome. Rate ceilings were common in Medieval Europe until emerging commercial activity overcame them, and some American States still maintain consumer credit rate ceilings today. Probably the clearest message that emerges from these 4,400 years of experience is that interest rate ceilings distort credit flows to the disadvantage both of borrowers who want to borrow and of savers who want to lend. For example, in 1981 the Government of the United States borrowed $392.5 billion to roll over maturing obligations and to finance new deficits. Apart from a small volume of below-market U.S. savings bonds and some no-interest borrowing by money printing, all U.S. borrowing in 1981 was done at a rate higher than 10 percent. Imagine all the consequences if a 10-percent ceiling had been in effect last year; the dislocations would have been immense. For example, more than $127 billion of U.S. Government obligations were held by foreigners at the beginning of last year. How much of this could have been rolled over at below-market rates? Not likely very much, which would have dramatically worsened the Treasury's financing difficulties, rather than improved them.

Very briefly, the impact of any below-market price ceiling is not to reduce the price of a good or service, but to create a shortage at the artificial price. One's memory need not be very long to remem-

ber the shortages and gas station lines when gasoline prices were controlled. The same would occur in credit markets if below-market ceilings were the rule. Below-market price would encourage demand but limit supply causing shortages to occur. There would be little encouragement in knowing that the price of credit were 10 percent if no credit were available at that price. The argument that lenders would have little choice but to lend anyway at 10 percent simply is unsupportable. If 10 percent were below the supply-demand equilibrium, foreign funds would disappear and American capital would rapidly flow overseas. The controls program necessary to try to enforce such a regime would further straightjacket economic progress. Even if it were possible to prevent massive domestic capital outflows—an unlikely prospect at best—a below-market usury ceiling would still create a credit shortage requiring rationing by some nonprice means.

Now the next question is what would be the consequences of such a system? In particular, whom would such a system help, and whom would it hurt? Among those harmed would be those eliminated from credit markets. Probably first to be eliminated would be newer and smaller businesses, farms, construction companies, and firms that are less financially stable. In other words, those likely to be eliminated first would be those most in need of access to credit. Also probably excluded would be those desiring credit with relatively large overhead costs per loan dollar, including consumer-credit and mortgage borrowers. Much later to be eliminated from the market would be financially strong major corporations and last would be the Federal Government itself. Unfortunately, people are unlikely to be pleased to learn that credit is unavailable to them or their new and small businesses to their Federal Government can claim more at artificially low rates.

A second obvious group to be harmed is savers, the providers of loanable resources. Contrary to popular belief this does not mean financial institutions—since, as we have seen, they are merely market intermediaries. The ultimate lenders in financial markets are the members of the public themselves. In addition to buying securities directly from ultimate borrowers, the public lends when it places deposits in a depository institution, purchases life insurance policies, or increases its pension fund reserves. Households' financial assets totaled $6.7 trillion at yearend 1981 according to statistical releases of the Federal Reserve Board. Any interest rate decision of the Congess that lowered the return on these assets would harm consumers. If returns on these assets were held below the rate of inflation, real wealth of the consumer sector would decline. The public would not be enthusiastic if Congress, whom many among the public already blame for inflation and erosion of the real value of wages, would now take further steps to erode the real value of prior savings as well.

In conclusion, there is nothing to recommend the concept of a national usury ceiling. High interest rates were not caused by the absence of such a ceiling. They were caused instead by massive Federal borrowing and by inflation due to past Federal policies. Thus, although a ceiling would do nothing to address the basic problem, it would have other severe and unfortunate consequences. Chief among the latter would be credit shortages as borrowers demand

more at artificial rates while lenders supply less. New and small businesses would suffer most, along with farmers, consumers, construction firms, and mortgage borrowers. On the lending side, disadvantages would accrue not only to financial intermediaries as credit markets disintegrated; but also to ultimate savers, the Nation's household sector. Already battered by inflation and recession, consumers would now watch the return on their savings deteriorate as well and see their real wealth diminish.

Thank you, Mr. Chairman. I am pleased to have the opportunity today to present NCFA's views on this matter as well as to have the chance of answering your questions.

[The prepared statement of Mr. Durkin, on behalf of the National Consumer Finance Association, follows:]

Statement of

Thomas A. Durkin

My name is Thomas A. Durkin. I am Director of Research and Education of the National Consumer Finance Association (NCFA)[1/] and Adjunct Senior Research Associate in Finance at the Pennsylvania State University. I welcome the opportunity to comment today on NCFA's views concerning bills before this Subcommittee that would set a national usury ceiling.

NCFA shares the concerns of the sponsors of these bills that market interest rates are too high. However, because these bills do nothing to repair the government policies that have produced high domestic interest rates, we question their usefulness. Furthermore, because these bills are likely to exacerbate our current economic difficulties by creating credit shortages, by disadvantaging the consumer sector of the economy, and by creating in one more area of the economy massive bureaucratic enforcement procedures, we must vigorously oppose their passage.

Interest is, of course, the price that those who need additional current resources are willing to pay to have them made

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1/ Organized in 1916, NCFA is the national trade association of companies engaged in the consumer credit business. NCFA represents over 600 companies operating more than 15,500 offices serving the public throughout the country. The membership of NCFA is highly diversified ranging from single, small loan offices to substantial nationwide financial services organizations engaged in unsecured direct lending, second mortgage lending and the financing of the sale of durable goods. The consumer finance industry accounts for over one-fourth of all consumer credit outstanding, or approximately $93 billion of the $332 plus billion outstanding.

available. Interest is paid to those with saved resources they are willing to lend - usually, in our economy, through financial institutions. Thus, financial institutions are conduits or intermediaries that channel resources from savers to borrowers, returning the interest borrowers are willing to pay and which savers require.

In an economy like ours with financial markets and institutions, the price of credit is determined like the price of anything else - by supply and demand in free markets. For any given supply of resources by savers, interest rates will rise if the demand for borrowing rises. Likewise, interest rates will fall if the demand for borrowing falls. Very simply, then, the interest rate at any time is the price of credit that just balances supply and demand. Any deviation of supply or demand from this balance will cause interest rates to move up or down.

In our complex economy with many potential users and borrowers of current resources, there is constant, active competition for funds. And, savers and intermediaries with resources to lend have become pretty sophisticated. They are not willing to lend to all on the same terms. Instead, they demand different compensation depending on risk, maturity, and amounts of costs involved in credit checking, bookkeeping, and operations. Furthermore, and most importantly, they also demand compensation for expected inflation. If prices of goods and services in the economy are expected to rise 10 percent in a year, suppliers of current resources are hardly likely to supply them for a 3 percent rate of interest. Rather, they will require an inflation premium on top of their usual interest requirement. If, for

example, their requirement for lending in a noninflationary economy is 3 percent, then if prices are expected to rise by 10 percent a year, resource providers will logically require 13 percent annual compensation. This is apart from the need to cover operating costs and the cost of risk.

Now, what has caused the recent high interest rates in the American economy? The answer is twofold - both, unfortunately, dependent on aspects of Federal policies that have developed over many years.

First of all, the Federal government's demand for funds has been almost insatiable in recent years. The desire to increase spending faster than revenues year in and year out has caused tremendous Federal demands on credit markets. While large deficits obviously could be financed without rising rates if savings expanded sufficiently rapidly, the mammoth size of recent and projected deficits has made this difficult indeed.

Second, Federal government policies have led to inflation. Government's spending more than income while financing part of the difference by printing new money has produced domestic inflation. High and long-rising inflation has created inflationary expectations. In this environment savers simply want higher interest rates before they are willing to lend resources.

In short, to use an analogy commonly employed these days, interest rates have become a thermometer measuring an aspect of the economy's health. High interest rates indicate the economy has a disease - massive Federal deficits and continuing inflationary expectations. The question is whether we will seek a cure instead of merely attempting to suppress the symptoms. Or,

worse yet, whether we will merely do violence to the thermometer while adding new economic ailments.

Now, having outlined briefly the causes of high and fluctuating interest rates, the next question is what would be the impact of a national usury law? Interest rate ceilings, of course, are not a new idea and so history can be a guide. Rate ceilings were tried as long ago as in the 24th century B.C. Laws of Manu in India. There also were ceilings in the Babylonian Code of Hammurabi and in the ancient laws of Greece and Rom . Rate ceilings were common in Medieval Europe until emerging commercial activity overcame them, and some American states still maintain consumer credit rate ceilings today. Probably the clearest message that emerges from these 4400 years of experience is that interest rate ceilings distort credit flows to the disadvantage both of borrowers who want to borrow and of savers who want to lend.

For example, in 1981 the Government of the United States borrowed $392.5 billion to roll over maturing obligations and to finance new deficits. Apart from a small volume of below-market U.S. Savings Bonds and some no-interest borrowing by money printing, all U.S. borrowing in 1981 was done at a rate higher than 10 percent. Imagine all the consequences if a 10 percent ceiling had been in effect last year; the dislocations would have been immense. For example, more than $127 billion of United States government obligations were held by foreigners at the beginning of last year. How much of this could have been rolled over at below-market rates? Not likely very much, which would have

dramatically worsened the Treasury's financing difficulties, rather than improved them.

Very briefly, the impact of any below-market price ceiling is not to reduce the price of a good or service, but to create a shortage at the artificial price. One's memory need not be very long to remember the shortages and gas-station lines when gasoline prices were controlled. The same would occur in credit markets if below-market ceilings were the rule. Below-market price would encourage demand but limit supply causing shortages to occur. There would be little encouragement in knowing that the price of credit were 10 percent if no credit were available at that price. The argument that lenders would have little choice but to lend anyway at 10 percent simply is unsupportable. If 10 percent were below the supply-demand equilibrium, foreign funds would disappear and American capital would rapidly flow overseas. The controls program necessary to try to enforce such a regime would further straight-jacket economic progress.

Even if it were possible to prevent massive domestic capital outflows - an unlikely prospect at best - a below-market usury ceiling would still create a credit shortage requiring rationing by some non-price means. Now the next question is what would be the consequences of such a system? In particular, whom would such a system help, and whom would it hurt?

Among those harmed would be those eliminated from credit markets. Probably first to be eliminated would be newer and smaller businesses, farms, construction companies, and firms that are less financially stable. In other words, those likely to be eliminated first would be those most in need of access to credit.

Also probably excluded would be those desiring credit with relatively large overhead costs per loan dollar, including consumer-credit and mortgage borrowers. Much later to be eliminated from the market would be financially strong major corporations and last would be the Federal government itself. Unfortunately, people are unlikely to be pleased to learn that credit is unavailable to them or their new and small businesses so their Federal government can claim more at artificially low rates.

A second obivous group to be harmed is savers, the providers of loanable resources. Contrary to popular belief this does not mean financial institutions - since, as we have seen, they are merely market intermediaries. The ultimate lenders in financial markets are the members of the public themselves. In addition to buying securities directly from ultimate borrowers, the public lends when it places deposits in a depository institution, purchases life insurance policies, or increases its pension fund reserves.

Households' financial assets totalled $6.7 trillion at year-end 1981 according to statistical releases of the Federal Reserve Board. Any interest rate decision of the Congress that lowered the return on these assets would harm consumers. If returns on these assets were held below the rate of inflation, real wealth of the consumer sector would decline. The public would not be enthusiastic if Congress, whom many among the public already blame for inflation and erosion of the real value of wages, would now take further steps to erode the real value of prior savings as well.

In conclusion, there is nothing to recommend the concept of a national usury ceiling. High interest rates were not caused by the absence of such a ceiling. They were caused instead by massive Federal borrowing and by inflation due to past Federal policies. Thus, although a ceiling would do nothing to address the basic problem, it would have other severe and unfortunate consequences. Chief among the latter would be credit shortages as borrowers demand more at artificial rates while lenders supply less. New and small businesses would suffer most, along with farmers, consumers, construction firms, and mortgage borrowers. On the lending side, disadvantages would accrue not only to fiancial intermediaries as credit markets disintegrated; but also to ultimate savers, the nation's household sector. Already battered by inflation and recession, consumers would now watch the return on their savings deteriorate as well and see their real wealth diminish.

I am pleased to have this opportunity to present NCFA's views on this matter, as well as to have the chance of answering your questions.

Chairman FAUNTROY. I thank you, Mr. Durkin. As with the previous panel, you have all made very persuasive arguments supporting your opposition to a national usury ceiling legislation. We have been joined by the distinguished gentleman from Florida, Mr. McCollum. I would be very pleased to have him open the question period for this panel.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman. I am very delighted to be with you, and you to be with us this morning. I know Dr. Rahn and I have had a chance to discuss this subject with him in the past. I want to make clear my concerns and my perspectives in this because I am an author of one of the bills which is being discussed today. I have absolutely no doubt about the validity of the testimony most of you have given this morning. The bottom line of this is that the best interest of this country would be served if we could agree here in Congress on how to get Congress more out of the business of putting pressure on interest rates, more out of the business of deficit financing, and more out of the credit market.

I happened to be engaged last week in an interesting battle on the floor of the House, which we won. It was, I guess, a minor bill, by public attention standards. But it dealt with the whole absorption of the credit market by the Federal Government and the ques-

tion of amendments to the Defense Production Act and loans and loan guarantees. It dealt with the entire pressures put on with the Federal Government either borrowing to finance the public debt or else competing out there in the marketplace for loans and loan guarantees as it absorbs such a high percentage of what little bit of money is available for the private sector to have.

I don't doubt for a minute that the price of money is interest rates. I don't doubt for a minute the laws of supply and demand are at work and should be at work here. And that in fact the real bottom line solution to our problem of higher interest rates and the problems we have today in the economy as a whole is reducing the consumption of available dollars by the Federal Government. The problem I have is the lack of consensus in this Congress on how to go about reducing it and the fact that we haven't reduced it and the effects that are going on in the meantime in the economy that might be harmful to any real recovery and might make the difficulty even greater.

So really my questions then center on the options that are available, making the assumption that we don't reach a consensus and we don't do the job we are supposed to be doing, as surely we haven't done it this year, of getting the Federal Government more out of the credit market. That leaves us for the short run of either leaving things the way they are today or letting deterioration continue, which can be with its ups and downs and won't be steady or constant I am sure.

We can see the Federal Reserve or other mechanisms in place through Congress taking action to reinflate the economy and pump more dollars out into the marketplace. Maybe in the short run, some have testified, alleviating the burdens of interest rates but in the long term, undoubtedly in my view at least increasing those interest rates, rather than really alleviating them. We can possibly go to some form of a usury ceiling. I want to ask Dr. Rahn a question related to that. You have addressed the problem of the usury ceiling very well with me privately as well as here today.

I recognize those problems. You have not today, at least I don't think I have seen it in your testimony, addressed the distinction in my bill with regard to indexing. May I assume correctly or incorrectly, you will have to tell me, that indexing the rate, the usury ceiling to the rate of inflation would at least minimize the problems other than money flowing elsewhere?

There are a lot of problems associated with usury ceilings in the country that are raised up in your testimony and I agree with them. What I am curious about is, does the indexing in your judgment or would the indexing minimize those problems with the exception of—and I understand this exception is very important, because we have discussed it before and we have discussed it today—credit money flowing somewhere else? I am curious about the other things.

Mr. RAHN. Well, I think we are dealing with a degree of badness here.

Mr. MCCOLLUM. Yes, sir.

Mr. RAHN. Clearly, if you have an appropriate index—and I have a lot of trouble with the Consumer Price Index; it is a greatly flawed index—the most creditworthy borrowers, let's say major cor-

porations, IBM, GE, for short-term interest, or short-term borrowings, would not have any trouble getting credit under your proposal. But smaller businesses, those who are looked on as less creditworthy, say young adults who have not established a credit track record, people who are lower income, and particularly people who are trying to get long-term loans such as home mortgages, they may find that they cannot get any legal credit at all. Their alternatives are either do not purchase, or turn to illegal sources. Your proposal I look at as only less harmful than some of the others.

But as you know, I still think it is not the way to go. These problems we are dealing with are only going to be successfully resolved if the Fed maintains a moderate rate of monetary growth at a steady level, and if Congress gets the growth of Federal spending and credit guarantees under control. There is no easy panacea.

Mr. MCCOLLUM. About that we certainly agree. I think you have adequately stated my view about it. I appreciate your clarification. With regard to the Fed possibly reinflating, Dr. Rahn, and with regard to a usury ceiling of some sort, I realize we are talking about two extremes that neither one of us want to face, do you have any way of judging which would be worse or are they equally bad in your judgment?

Mr. RAHN. Well, we have seen the negative side of rapid monetary growth, which invariably leads to recession, high unemployment and to the kind of adverse circumstances we have faced in the last couple of years and are now forced to correct. In either case, the impacts, the downside effects fall on those people, individuals and businessmen, who are normally less able to cope in society. This is something I think is often not recognized, that poor economic policy always hits the least educated, the younger people who are the least competitive, most severely. Those who are in more favorable circumstances can usually cope under all kinds of adverse circumstances.

Mr. MCCOLLUM. Thank you.

Mr. Brunner, I have probably exhausted most of the time the chairman should be giving me at this point. I am going to yield back to him. I just want to comment to you that I appreciate very much your testimony today and respect, being from Florida, particularly the problems of senior citizens. I, in fact, have a bill in today that I wish the economy would permit my colleagues to join more forcibly behind to eliminate taxing interest and dividends for senior citizens altogether because of the reasons you have testified to.

Mr. Durkin, I also appreciate your comments. I would like to comment, though, that in the legislation I did introduce—the bureaucracy would not exist in my particular bill. There is no Federal involvement to enforce anything. It is purely market play. I did want to make sure that you recognized or understood that that was an exception to this particular bill. Due to the fact we may get a vote as we often do at noon I am going to yield back to the chairman so you have an opportunity to ask your questions. I appreciate the opportunity to ask mine.

Chairman FAUNTROY. I thank the gentleman and appreciate his faithfulness in attending many of our hearings on domestic monetary policy during this 97th Congress. I knew, given your interest

in this whole subject matter area, that you would want to have an opportunity to query our witnesses.

Dr. Rahn, you noted in your statement that were a national usury ceiling imposed, large corporations could issue stock with implicit promises to pay holders a return that is in excess of the usury ceiling. While you were specifically noting that stock might be preferred stock, there is no reason that it need be. Let me ask you whether or not a return to equity financing, instead of debt financing, might not be a good thing. Isn't one of the problems with our big companies, International Harvester, for example, that they have too much debt and not enough equity?

Mr. RAHN. Very quickly, yes. I would just like to address a comment Mr. McCollum made regarding alleviating taxation of interest and dividends for senior citizens. My only complaint with that is he doesn't go far enough. It ought to be alleviated for everybody. If we did such, I realize I am digressing here slightly, it would not have any negative economic consequences because you would be increasing the supply of savings by the same amount that you increased the Federal debt. It would have no negative impact on interest rates at all. Over the long run it would add to capital formation and be healthy for the economy. I would encourage you to go full steam ahead with that.

Mr. MCCOLLUM. Thank you.

Mr. RAHN. Regardless of the current economic situation we face, Mr. Chairman, you are absolutely correct. Our problem is too much debt and not enough equity in society. This goes back to the nature of our tax laws, which discriminate against savers, reward borrowers, and particularly discriminate against those people who are holders of equity because of double taxation of corporate dividends, and so forth. We need to redress that by reducing the discrimination against people who save and against people who are equity holders vis-a-vis borrowers.

Chairman FAUNTROY. Mr. Durkin, if people with loanable funds were unable to receive a rate in excess of some set usury rate, what would they do with their funds?

Mr. DURKIN. They would probably use it to purchase real assets, or they could lend the funds overseas. Also, things would happen in the economy that are unforeseen. Just as money market funds, for example, came into being as a way of getting around regulation Q interest rate ceilings on deposits at depository intermediaries, new kinds of things would undoubtedly happen. As one of our panel, I believe Mr. Brunner, mentioned a moment ago, as water seeks its own level, so does money. Unfortunately, the level for water is lower and for money it is higher. I think the same thing would happen here. New institutions, new offshore financing, flows of funds overseas, withdrawal of capital by foreigners from America would undoubtedly take place and there would be things that are probably unforeseen at the present time requiring the development of an enforcement procedure, a Federal bureaucracy, an allocation procedure for remaining capital. These kinds of consequences are at present difficult to foresee, but undoubtedly they would come into being.

Chairman FAUNTROY. I thank you. Mr. McCollum, the House is in session. If there are any burning questions you would like to ask the panel now, I would be pleased to receive them.

Mr. MCCOLLUM. Well, I thank you very much, Mr. Chairman. I really do not have any questions. I have explored this area privately with Dr. Rahn considerably. I appreciate the panel. I wish I had more time. I don't think I would do justice either to Mr. Brunner or Mr. Durkin to pursue this in the detail that I might like to otherwise.

Thank you, though.

Chairman FAUNTROY. Gentlemen, I want to thank you as well. We have had a very full and expert day of testimony on a subject that is obviously of great concern to the American people, and I want to thank you for your contribution and understanding of the problems involved in our consideration and possible disposition of national usury ceiling legislation.

The hearing is adjourned.

[Whereupon, at 12 noon, the subcommittee was adjourned, to reconvene subject to the call of the Chair.]

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